OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **PARTNERSHIP OF E. DAMADIAN, ET AL., dba Primo Café**	OTA Case No. 18093766 CDTFA Case ID: 795993

OPINION

Representing the Parties:

For Appellant:	Mitchell Stradford, Representative
For Respondent:	Randy Suazo, Hearing Representative Jason Parker, Chief of Headquarters Ops. Kevin Smith, Tax Counsel III
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, the partnership of E. Damadian, P. Zerounian, and C. Nasser (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated January 28, 2014.[2] The NOD is for tax of $72,337.79, plus applicable interest, and a negligence penalty of $7,233.78, for the period January 1, 2009, through December 31, 2011 (liability period). After issuance of the NOD, CDTFA reduced the tax liability from $72,337.79 to $35,129.07, deleted the negligence penalty, and denied the remainder of the petitioned amount.

[1] Sales and use taxes were formerly administered by the State Board of Equalization (BOE). Effective July 1, 2017, functions of BOE 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" refers to BOE.

[2] The NOD was timely issued because on March 13, 2013, appellant signed a waiver of the otherwise applicable three-year statute of limitations, which allowed CDTFA until January 31, 2014, to issue an NOD for the period January 1, 2009, through December 31, 2011. (R&TC, §§ 6487(a), 6488.)

Office of Tax Appeals (OTA) Administrative Law Judges Suzanne B. Brown, Josh Lambert, and Andrew J. Kwee held an oral hearing for this matter in Sacramento, California, on April 20, 2022. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUE

Whether any further adjustments are warranted to the audited understatement of reported taxable sales for the liability period.

FACTUAL FINDINGS

1. Appellant operated a restaurant as a partnership in Lancaster, California, from January 12, 1998, through September 30, 2014, when the business was incorporated. The restaurant, Primo Café, was an American-style family diner and served beer and wine.
2. During the liability period, appellant reported total sales of $2,970,995, claimed deductions of $215,039 for sales tax included, and reported taxable sales of $2,755,956.
3. For audit, appellant provided federal income tax returns (FITRs) for 2009, 2010, and 2011; sales and use tax returns (SUTRs); and bank statements.
4. In its preliminary review of the records, CDTFA found that: 1) for 2009, total sales reported on SUTRs exceeded the gross receipts reported on appellant's FITRs by $23,453; 2) for 2010, the gross receipts reported on FITRs exceeded total sales reported on SUTRs by $19,949; and 3) for 2011, total sales reported on SUTRs reconciled with gross receipts reported on FITRs.
5. CDTFA noted that the cost of goods sold reported on each FITR included purchases, cost of labor, and other costs (which CDTFA identified as purchases of supplies). For the years 2009, 2010, and 2011, respectively, the FITRs reported the following amounts: purchases of $369,008, $364,092, and $432,951; costs of labor of $223,229, $228,772, and $238,776; and "other costs" of $7,982, $7,697, and $12,507.
6. CDTFA used the gross receipts and purchases reported on FITRs to compute achieved markups of 136 percent, 145 percent, and 128 percent (rounded) for 2009, 2010, and 2011, respectively, and an achieved markup for the three-year period of 136 percent. Since CDTFA expected a markup of at least 200 percent for this type of business, it concluded that further investigation was warranted.

7. CDTFA decided to analyze reported sales using the credit card ratio projection of sales audit method. CDTFA observed appellant's sales for three full days: Monday, January 7, 2013; Thursday, March 28, 2013; and Saturday, April 20, 2013. For those days, CDTFA computed credit card sales to total sales ratios (hereinafter credit card ratios) of 38.39 percent, 64.55 percent, and 64.68 percent, respectively, and 58.67 percent overall.

8. CDTFA divided audited credit card deposits by 58.67 percent[3] to compute audited total sales including tax. CDTFA calculated audited taxable sales of $3,524,812, which exceeded reported taxable sales of $2,755,956 by $768,861.

9. On January 28, 2014, CDTFA issued the NOD for tax of $72,337.79, plus applicable interest, and a negligence penalty of $7,233.78. On February 19, 2014, appellant filed a timely petition for redetermination.

10. On June 16, 2015, CDTFA's Appeals Bureau held an appeals conference, during which CDTFA agreed to delete the negligence penalty. After the conference, CDTFA reviewed appellant's submission and found that it supported a reduction of the audited understatement to $390,454.

11. On November 20, 2015, CDTFA's Appeals Bureau issued a Decision and Recommendation (D&R), recommending a reaudit to: 1) recompute the audited credit card ratio using only the observation test results for the last two observation days, March 28 and April 20, 2013, and excluding the January 7, 2013 observation test results due to errors in the audit's recorded results for that day;[4] 2) review appellant's bank statements, and, if deemed accurate, use the credit card deposits recorded on those statements in the audit computations; 3) compute a percentage for nontaxable optional gratuities (tips) included in credit card deposits for the last two observation days, excluding guest check 1692, dated April 20, 2013; 4) compute the adjustment for sales

[3] In the audit, CDTFA made no adjustment for tips included in credit card receipts. However, CDTFA made adjustments for tips during the reaudits.

[4] Appellant stated that the January 7, 2013 observation test data contained errors and discrepancies including duplicate transactions, payment methods that could not be verified, and errors in classifying transactions as cash or credit card sales; according to the D&R, CDTFA agreed that the January 7, 2013 observation data were not accurate, but it proposed making revisions to correct the errors.

tax reimbursement included in bank deposits using the formula set forth in CDTFA's Audit Manual section 0810.12; and 5) delete the negligence penalty.

12. Subsequently, CDTFA conducted a reaudit and calculated that $2,249,015 was the amount of credit card deposits recorded on appellant's bank statements, and used that amount for the audit computations. Also in the reaudit, CDTFA made an adjustment for optional tips included in credit card sales, computed at 8.39 percent.[5] Overall, this reaudit found a percentage of error of 5.89 percent for the liability period.

13. On April 26, 2016, CDTFA issued a reaudit report showing a measure of unreported taxable sales of $162,325 and a tax liability of $15,281.36.

14. Appellant requested a State Board of Equalization (BOE) hearing, which was scheduled for March 29, 2017. On February 2, 2017, appellant filed an opening brief for the BOE hearing. On February 15, 2017, CDTFA requested that the BOE hearing be deferred.

15. On March 10, 2017, CDTFA sent an email to its Appeals Bureau regarding the D&R and the reaudit; the email stated in part that there were various errors in an audit schedule for the January 7, 2013 observation test and that the audit at that point was not defensible, but argued that CDTFA had sufficient documentation in the files to correct those errors. Thereafter, CDTFA's Appeals Bureau treated this email as a Request for Reconsideration of the D&R.

16. On October 3, 2017, CDTFA's Appeals Bureau issued a Supplemental Decision and Recommendation (SD&R), recommending a reaudit to correct the errors in the January 7, 2013 observation test results, and to incorporate the results into the computation of the audited credit card ratio, instead of eliminating the results of that test day from the audit as the D&R had recommended. The SD&R also recommended that CDTFA support the reasonableness of the reaudit results by computing the audited understatement using another indirect audit method.

17. CDTFA conducted a second reaudit in which it corrected errors in the January 7, 2013 observation test results; as a result, CDTFA revised the credit card ratio for that day from 38.39 percent to 44.50 percent. For the three test days combined, CDTFA computed that tips represented 8.18 percent of credit card receipts and that the ratio of credit card sales

[5] The percentage of tips included in credit card receipts was computed using the data gathered from the March 28 and April 20, 2013 observation tests.

to total sales was 60.20 percent. In the second reaudit, CDTFA used the amount of credit card sales verified with Form 1099-K reports, $2,245,040, rather than the total of $2,249,015 that was deposited in appellant's bank account.[6]

18. On October 23, 2017, CDTFA issued a second reaudit, increasing the measure of unreported taxable sales from $162,325 (established in the first reaudit) to $373,156, and thus increasing the tax liability from $15,281.36 to $35,129.07. The second reaudit found a percentage of error of 13.54 percent for the liability period.

19. In the second reaudit, CDTFA used two alternative indirect audit methods to evaluate the reasonableness of the audit findings. First, it used the amounts of credit card receipts and reported taxable sales for this business for the period July 1, 2013, through September 30, 2014, to compute that reported sales represented 1.3603 of credit card receipts. It then multiplied the credit card receipts for this liability period by 1.3603 to compute sales of $3,059,337, which exceeded reported taxable sales of $2,755,956 by $303,381. Second, CDTFA used industry standard markups of 168.82 percent (for higher-cost operations) and 210.56 percent (for median-cost operations), along with the amounts of purchases reported on appellant's FITRs, to compute understatements of $378,590 and $865,320, respectively; CDTFA considered these results as secondary support for the audited understatement of $373,156.

20. This timely appeal followed.

DISCUSSION

California imposes a 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, § 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC § 6091.) It is the retailer's responsibility to maintain complete and accurate records and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When a taxpayer challenges an NOD, CDTFA has a minimal, initial burden of showing that its determination is reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) If

[6] Form 1099-K, "Payment Card and Third Party Network Transactions," is an IRS form that shows amounts paid to a merchant by a bank, credit card company, or third party network when the customer pays for goods or services using a debit card, credit card, PayPal, or similar non-cash payment.

CDTFA carries that 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.) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.) To satisfy its burden of proof, a taxpayer must prove both (1) that the tax assessment is incorrect and (2) the proper amount of the tax. (*Appeal of AMG Care Collective*, *supra*; *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442.)

In general, sales of food are exempt from tax. (R&TC, § 6359.) However, certain sales of food are excluded from the exemption (and are thus subject to tax). As relevant here, sales of food are subject to tax if the food is sold for consumption at facilities provided by the retailer (R&TC, § 6359(d)(2)) or if the food is sold as hot prepared food products (R&TC, § 6359(d)(7)).

When more than 80 percent of a retailer's gross receipts are from sales of food products, and over 80 percent of its retail sales of food are subject to tax, then cold food sold in a form suitable for consumption on the retailer's premises is subject to tax even if it is purchased "to go." (R&TC, § 6359(d)(6).) When a retailer's sales fit within this provision, known as the "80/80 rule," the retailer may avoid its application by keeping a separate accounting of its sales to-go of cold food in a form suitable for consumption on the retailer's premises. (R&TC, §6359(f); Cal. Code Regs., tit. 18, § 1603(c)(1)(A).) Here, it is undisputed that appellant's sales meet the criteria of the 80/80 rule and that all of appellant's sales are taxable.

In this case, CDTFA found that appellant's reported sales achieved markups on cost of 136 percent, 145 percent, and 128 percent (rounded) for 2009, 2010, and 2011, respectively, and an average achieved markup of 136 percent for the three-year period. Those markups are significantly lower than the industry average markup of at least 200 percent that CDTFA expects for a restaurant. Additionally, CDTFA's examination of appellant's bank statements disclosed that 98 percent of the deposits to its bank account were credit card deposits, yet this amount was only 74.73 percent of its reported total sales, indicating that appellant mostly did not deposit cash sale proceeds in its bank account. Moreover, when books and records are provided, CDTFA may still determine the amount of tax due based upon any available information, even if

such books and records are comprehensive and internally consistent. (*Appeal of Amaya*, 2021-OTA-328P.) Hence, it was reasonable for CDTFA to utilize an indirect audit method in this case. The credit card ratio method is a recognized and standard audit procedure that is effective in establishing taxable sales because it relies on the amount of credit card receipts, which is readily verifiable information. (See *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616; see, e.g., CDTFA Audit Manual § 0810.12.) OTA finds that the credit card ratio method was appropriate for this audit. In addition, OTA has found no errors in the second reaudit's computations. In light of all the evidence, OTA finds that CDTFA has shown that its determination is reasonable and rational. Consequently, appellant has the burden to show that additional adjustments are warranted.

Appellant contends that it was not appropriate to include the data from the January 7, 2013 observation test in the second reaudit's computations because the results from that observation day are unreliable due to material errors. Appellant states that the January 7, 2013 observation data contained duplicate entries, errors in classifying transactions as cash or credit card sales, and transactions for which the method of payment could not be identified; appellant emphasizes that CDTFA's March 10, 2017 email acknowledged that the audit was "not defensible." Appellant also notes that the observation was conducted by an auditor from another CDTFA field office who was not otherwise responsible for the audit.

While the January 7, 2013 observation data in the original audit contained the errors that appellant identified, CDTFA corrected those errors in the second reaudit. Accordingly, the arguments regarding the prior errors in those results are no longer relevant. Likewise, CDTFA's March 10, 2017 email comments refer to the audit prior to the corrections in the second reaudit, not to the second reaudit's results at issue here. In light of all evidence, OTA finds that the prior errors do not establish a basis for disregarding the second reaudit's corrected results of the January 7, 2013 observation test.

Further, appellant contends that the first observation day was a slow day that was not representative of appellant's business. In particular, appellant notes that the credit card sales ratios for each of the other two test days were significantly higher than the ratio for the first test day (44.5 percent compared to about 65 percent for the other two days). As support, appellant computed that average daily gross credit card sales equate to $2,078. In comparison, the gross credit card receipts for January 7, 2013, were $1,116, which is 53.7 percent of $2,078.

According to appellant, this disparity is evidence that the sales on January 7, 2013, were not representative of its business.

OTA finds that the lower amount of credit card receipts, by itself, does not constitute grounds for removing the January 7, 2013 observation day from the test results. Amounts of credit card receipts and the ratios of credit card sales to total sales are expected to vary each day for any business. Given that such fluctuations exist, CDTFA's Audit Manual specifies that observation tests should encompass at least three full days and will be conducted on at least one weekend day, if possible (CDTFA Audit Manual § 0810.30); generally, the reliability of the audited percentage increases as the period of review increases. Moreover, here the credit card receipts for March 28, 2013, and April 20, 2013, were $2,706 and $2,758, respectively, and the average for the three days is $2,193.[7] Since that figure is reasonably comparable to appellant's calculation of the $2,078 average for the liability period, OTA finds there is no convincing evidence that the sales for January 7, 2013, were unrepresentative of appellant's business. For these reasons, OTA finds that the lower amount of credit card receipts on Monday, January 7, 2013, is not a basis for excluding the data for that day from the audit computations. In light of all of the above, it was appropriate for the second reaudit to utilize the corrected data from the January 7, 2013 observation test.

Appellant also argues that its achieved markups are higher than those computed in CDTFA's preliminary examination of its records. Appellant further argues that its achieved markups are within the range of markups CDTFA expects for this type of business and, therefore, they offer evidence that reported taxable sales are substantially accurate. Specifically, appellant has calculated achieved markups ranging from 164 percent to 218 percent for each month of 2011, with a markup for the year of 184 percent. In its computations, appellant has used food costs, as recorded on its monthly worksheets, which it has reduced by 12 percent before comparing sales and costs. Appellant states that Chapter 8 of CDTFA's Audit Manual includes standard allowances, such as a standard allowance of 2 percent for pilferage. However, OTA finds that typically such adjustments are incorporated into the computations when an audit is conducted on a markup basis (see CDTFA Audit Manual § 0809.30),[8] which is not the case

[7] $1,116 + $2,706 + $2,758 = $6,580; $6,580 ÷ 3 = $2,193.

[8] CDTFA Audit Manual section 0809.30 specifically provides that if the mark-up method is used to establish audited taxable sales, the auditor should make a separate adjustment for pilferage and for spoilage.

here. In this case, the audit does not factor in the achieved markup in determining the liability, so appellant's arguments are inapplicable. Additionally, OTA can find no authority or basis for making such adjustments when the sole purpose of calculating the achieved markup is to determine whether further investigation is warranted.

As another element of this argument, appellant asserts that the achieved markups computed by CDTFA (136, 145, and 128 percent, respectively for 2009, 2010, and 2011) were calculated using costs of goods sold that included wages. In its computations of the achieved markups, CDTFA used only the amounts segregated as "purchases" in the cost of goods sold category on appellant's FITRs. CDTFA excluded the amounts segregated as "labor." Thus, it appears from the entries on the FITRs that CDTFA has not included any amounts of wages in the costs of goods sold used to compute achieved markups.

In support of its position that CDTFA used incorrect costs of goods sold in its computations, appellant provided monthly worksheets for each month of 2011. The handwritten worksheets appear to show a total of $395,769 in food costs for the year, while the amounts recorded as payroll total $258,193 for the year. In comparison, the amounts reported on appellant's FITR for 2011 were $432,951 (purchases) and $238,776 (labor). Therefore, the totals of amounts recorded on the monthly worksheets are not significantly different from the amounts recorded on the FITRs. Moreover, if OTA uses the $395,769 total of food purchases recorded on monthly worksheets, the result is a markup of approximately 150 percent [($988,067 - $395,769) ÷ $395,769], which is greater than the 128 percent CDTFA computed using the amount shown on the FITR but still much lower than the markup CDTFA expected for a restaurant.

This Opinion has already found that it was appropriate for CDTFA to use an indirect audit method, and appellant's computations of somewhat higher achieved markups does not establish otherwise. Accordingly, OTA finds that no adjustment is warranted on the basis of appellant's argument that its achieved markups were higher than those CDTFA calculated in its preliminary review of the records.

Appellant has also raised arguments about the original audit and first reaudit that have been rendered moot because they address CDTFA's prior positions that are no longer part of the audited understatement at issue. For example, appellant refers to CDTFA's basis for not making an adjustment in the audit to account for tips included in credit card receipts. As explained

above, CDTFA made an adjustment in the second reaudit for tips of 8.18 percent (based on its observation tests). Also, appellant points to a cash payout analysis that CDTFA previously offered as evidence that the audit findings were reasonable. In addition, appellant disputes a comment from CDTFA asserting that the amount of income reflected on appellant's FITRs seemed low for a business with three partners. The latter two assertions were part of CDTFA's previous position supporting the original audit, but are not part of the findings in the SD&R or the second reaudit; hence, those prior positions are not pertinent here and will not be discussed further.

Appellant's overall argument, which incorporates some of the elements addressed above, is that its reported taxable sales were substantially accurate and that the liability should be deleted. Appellant notes that the credit card ratio computed using the March 28 and April 20, 2013 observation data is 64.53 percent, which appellant contends is not substantially different from the recorded credit card ratio of 67.72 percent that it has computed for 2011. Appellant also notes that the percentage of error computed in the first reaudit was 5.89 percent, which appellant argues is strong evidence that reported taxable sales were substantially accurate.

This Opinion has concluded that it was appropriate for the second reaudit to include the corrected results from the January 7, 2013 observation test. Thus, OTA finds unpersuasive appellant's arguments relying only on the data from the observation tests for the other two days; hence, appellant has not shown that its reported sales were substantially correct. Moreover, as discussed above, in the second reaudit CDTFA used two additional indirect audit methods to evaluate the reasonableness of the audit findings. In particular, the first of those methods utilized appellant's own records for the period July 1, 2013, through September 30, 2014, to compute that total sales represented 1.3603 of credit card receipts. CDTFA then multiplied credit card receipts for this audit period by 1.3603 to compute sales, which exceeded reported taxable sales by $303,381; that amount is close to the audited understatement at issue, $373,156. Thus, these results provide strong support for the audit findings.

Further, OTA computes that the average daily sales amount for the three observation days was $3,302.[9] In comparison, audited sales are $2,897 per day.[10] Thus, the average daily sales

[9] $2,140 + $3,845 + $3,922 = $9,907; $9,907 ÷ 3 = $3,302.

[10] Reported taxable sales of $2,755,956 + deficiency measure of $373,156 = audited taxable sales of $3,129,112; assuming 360 days operating each year, $3,129,112 ÷ 360 ÷ 3 = $2,897.

established by audit are $405 less than the daily sales observed in the three test days. While the days of observation were in early 2013, compared to the liability period covering the years 2009 through 2011, the observed average daily sales are nearly 14 percent higher than the audited average daily sales.[11] OTA finds that level of price increase, from the liability period to the dates of CDTFA's observation of the business, to be entirely plausible. Consequently, this comparison of audited daily sales and the daily sales reflected in the observation tests offers secondary support for the audit findings.

Additionally, appellant argues that CDTFA's March 10, 2017 email and additional internal email correspondence among CDTFA employees show that those CDTFA employees colluded to assert a higher liability against appellant. Appellant obtained the additional emails via requests under the Public Records Act (Gov. Code, § 6250 et seq.), but large portions of the emails' contents were redacted by CDTFA's Disclosure Office.

OTA has no jurisdiction to decide whether CDTFA violated the Public Records Act, the Information Practices Act (Civ. Code, § 1798 et seq.), or any similar provision of the law. OTA also lacks jurisdiction to consider whether a taxpayer is entitled to a remedy for CDTFA's actual or alleged violation of any substantive or procedural right, unless the violation affects the adequacy of a notice, the validity of an action from which a timely appeal was made, or the amount at issue in the appeal. (Cal. Code Regs., tit. 18, § 30104(d).) Here, our only inquiry is to determine whether adjustments are warranted to the audited understatement for the liability period. (See *Appeals of Dauberger, et al.* (82-SBE-082) 1982 WL 11759.) Thus, under any circumstances, OTA's analysis of this issue must consider the same questions: whether CDTFA has met its initial established burden of showing that its determination is reasonable and rational, and if so, whether appellant has shown that a result differing from CDTFA's determination is warranted. As discussed above, this Opinion has reached those conclusions based on the evidence. Accordingly, OTA finds that appellant has not shown that further adjustments are warranted.

[11] $3302 - $2,897 = $405; $405 ÷ $2,897 = 14 percent.

HOLDING

No further adjustments are warranted to the audited understatement of reported taxable sales.

DISPOSITION

Sustain CDTFA's decision to reduce the determined amount of tax to $35,129.07, delete the negligence penalty, and otherwise deny the petition.

DocuSigned by:
Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

We concur:

DocuSigned by:
3CADA62FB4864CB...
Andrew J. Kwee
Administrative Law Judge

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

Date Issued: 7/25/2022