OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011982
	) CDTFA Case ID 873161
PACIFIC DINING CAR, INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Steve Mather, Attorney
For Respondent:	Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Pacific Dining Car, Inc. (appellant) appeals a Decision and Recommendation (Decision) issued by the California Department of Tax and Fee Administration (respondent[1]) denying appellant's petition for redetermination of the Notice of Determination (NOD) issued on April 24, 2015. The NOD was for $246,008.87 in tax, plus accrued interest, and a negligence penalty of $24,600.93 for the period January 1, 2012, through March 31, 2014 (liability period).

This appeal is being decided on the basis of the written record because appellant waived an oral hearing.

ISSUES

1. Is a further reduction to the amount of unreported taxable sales warranted?
2. Did respondent correctly impose the negligence penalty?

[1] Prior to July 1, 2017, sales and use taxes (and other business taxes and fees) were administered by respondent's predecessor, the State Board of Equalization (BOE). When this Opinion refers to events that occurred before July 1, 2017, "respondent" refers to BOE.

FACTUAL FINDINGS

1. Appellant operated two steakhouse restaurants with bars, one in Los Angeles since July 1980 and the other in Santa Monica since October 1990. According to appellant's president, appellant used data from its point-of-sale (POS) system to prepare sales tax worksheets.[2] Respondent previously audited appellant for the period January 1, 1986, through December 31, 1988.[3]
2. For the liability period, appellant reported total sales of $10,909,648, and claimed deductions of $548,907 for discounts (such as coupons), which resulted in reported taxable sales of $10,360,741.
3. For audit, appellant provided its federal income tax return (FITR) for 2012, bank statements, and its general ledger for the liability period. Respondent found that the gross receipts reported on the FITR for 2012 exceeded the total sales reported on appellant's sales and use tax returns (SUTRs) for 2012 by $962,301. Respondent then compared the total sales reported on the SUTRs for 2012 with the cost of goods sold (COGS) reported on the 2012 FITR and calculated a book markup of 172 percent,[4] which was lower than respondent expected for this business.[5] On the basis of these findings, respondent decided that additional testing would be required to verify the accuracy of appellant's reported taxable sales.
4. Appellant's bank records (from two banks) for the period April 2011 to March 2014 show cash deposits from sales of $1,000 (all in October 2013) and credit card deposits from sales of $18,070,373, including tips and sales tax reimbursement. Credit card

[2] A point-of-sale terminal is the modern equivalent of a cash register. Depending on the equipment and software, POS systems can generate "Z-tapes," which are summaries of sales activity from the time a terminal is opened to the time it is closed out, which can happen as often as the operator chooses. A Z-tape can include breakdowns of sales by type and amount, including product or service, credit or cash, and taxable or nontaxable.

[3] There is apparently no dispute that there was a prior deficiency audit of appellant, but records regarding the details of that audit are no longer available.

[4] "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 $0.70 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 (0.30 ÷ 0.70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

[5] The audit work papers indicate respondent expected a markup of at least 200 percent.

deposits from sales during the liability period totaled $13,543,084, or $10,765,602 after deducting estimated tips (at 15 percent) and sales tax reimbursement.

5. Respondent compared the gross receipts (excluding sales tax reimbursement and tips) recorded in appellant's general ledger with the recorded COGS to calculate overall book markups of 237 percent for 2012, 239 percent for 2013, and 289 percent for the first quarter of 2014 (1Q14). Respondent then used appellant's general ledger to calculate book markups ranging from 221 percent to 262 percent for food, from 318 percent to 386 percent for liquor, and from 224 percent to 295 percent for wine. Respondent found that the book markups calculated from appellant's general ledger were more in line with what respondent expected for restaurants like these, and on this basis concluded that they supported the accuracy of the amounts recorded in the general ledger.
6. Respondent compared appellant's recorded taxable sales from its general ledger with appellant's reported taxable sales for the liability period, and computed an understatement of $2,714,897, which formed the basis of the NOD issued to appellant on April 24, 2015.[6] Respondent added a 10 percent penalty for negligence and issued the NOD.
7. Appellant filed a timely petition for redetermination protesting the NOD in its entirety. On July 13, 2016, the parties participated in an appeals conference as part of respondent's internal appeals process. Appellant argued then that a dishonest former bookkeeper stole money from appellant and mismanaged appellant's financial records, in part by importing sales information from its POS system multiple times, thus artificially inflating the taxable sales amounts shown in appellant's general ledger.
8. Before issuance of respondent's Decision, respondent discovered a computational error in the original audit and agreed to adjust the liability for discounts and complementary food and beverages provided to appellant's employees and others. After calculating these adjustments, respondent recommended a $494,010 reduction to the deficiency measure, from $2,714,897 to $2,220,887.
9. As part of its further analysis following the appeals conference, and to verify that its

[6] Respondent added recorded food sales, liquor sales, and wine sales for 2012, 2013 and 1Q14, deducted reported taxable sales for those periods, and used the difference to compute percentages of error, which it then multiplied times recorded total sales per quarter to calculate unreported taxable sales.

determination was reasonable, respondent performed a credit card sales ratio analysis, using IRS Forms 1099-K (1099s).[7] Respondent adjusted the recorded non-cash sales total of $13,645,003 (i.e., usually amounts paid using a credit or debit card) to exclude sales tax reimbursement (at the applicable rate per quarter) and tips (estimated at 15 percent[8]). Respondent used the resulting $10,896,468 amount and an 85 percent estimate of the ratio of non-cash sales to total sales (credit card sales ratio) to calculate a $12,819,375 estimate of appellant's taxable sales during the liability period, which exceeded appellant's reported taxable sales by $2,458,634, $237,747 more than the already reduced measure at issue.[9] On the basis of this analysis, respondent concluded that its current recommendations are reasonable.

10. In its Decision, respondent recommended that the determined measure of tax be reduced by $494,010, from $2,714,897 to $2,220,887, and that the petition otherwise be denied. This timely appeal followed.

DISCUSSION

Issue 1: Is a further reduction to the 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 until the retailer proves otherwise. (R&TC, § 6091.) Although gross receipts from the sale of "food products" are generally exempt from sales tax pursuant to R&TC section 6359(a), sales of food served in a restaurant are subject to tax. (R&TC, § 6359(d)(1).) Sales of hot food to-go are also subject to tax (R&TC, § 6359(d)(7)). Although sales of cold food to-go generally qualify for the exemption, if over 80 percent of a retailer's gross receipts are

[7] A credit card sales ratio analysis typically involves the use of third-party data, such as bank statements or 1099s, which 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. Ideally, sales transactions for a representative period are examined to determine the ratio of such non-cash sales to total sales (credit card sales ratio). Gross receipts are computed by deducting sales tax reimbursement and tips included in the amounts deposited. The total sales amount is then calculated by dividing the gross receipts amount by the credit card sales ratio.

[8] According to the Decision, appellant's president (at the time) estimated tips at 10 to 20 percent.

[9] Appellant's then-president claimed that 85 to 90 percent of appellant's clientele were non-cash customers.

from the sale of food products, and over 80 percent of the retailer's sales of food products are subject to tax, all food products furnished in a form suitable for consumption on the seller's premises, including cold food sold to-go, are usually subject to tax.[10] (R&TC, § 6359(d)(6).)

If 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.) It is the taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability, 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).)

When a taxpayer appeals a deficiency determination based on underreported taxable sales, 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 that burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent'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, the taxpayer 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*, OTA-2020-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.)

The first question is whether respondent has met its initial burden of showing that it used reasonable results from a rational audit approach to determine the asserted deficiency. Here, respondent found that the gross receipts reported on appellant's 2012 FITR exceeded reported total sales by $962,301, and that the book markup was lower than expected. Either of those findings provided a reason to question the accuracy of appellant's reported taxable sales and to proceed with further investigation.[11] After determining that the amounts of taxable sales recorded in appellant's general ledger were reasonable, respondent established unreported

[10] This is sometimes referred to as the 80-80 Rule. (Cal. Code Regs., title 18, § 1603(c)(3).)

[11] This Opinion is not stating or implying that respondent's authority to look behind a taxpayer's records is limited to when those records appear to be inconsistent, inaccurate, or unreliable. (See *Appeal of AMG Care Collective*, 2020-OTA-173P, at p.11; *Appeal of Amaya*, 2021-OTA-328P, at pp. 5-6.)

taxable sales based on a comparison of taxable sales recorded in appellant's general ledger with appellant's reported taxable sales. Information in appellant's general ledger is direct evidence of what is recorded there, including appellant's taxable sales. Appellant does not argue, and has not provided evidence to show, that respondent inaccurately scheduled or calculated appellant's recorded taxable sales for the liability period. The evidence thus shows that respondent reasonably relied on the recorded amounts to establish audited taxable sales. Therefore, respondent has carried its burden of proving that the determination has a reasonable and rational basis. Consequently, the burden of proof shifts to appellant to prove that its recorded amounts are wrong or to provide other evidence demonstrating that a further reduction to the measure of unreported taxable sales is warranted.[12]

Initially, appellant argued that its former bookkeeper mismanaged appellant's financial records, creating many errors in its general ledger and thus rendering the general ledger inaccurate and unreliable.[13] To support its argument that an accurate determination of its liability, if any, cannot be based on its general ledger, appellant provided what purport to be quarterly summary reports from its POS system, and it argues that these reports are the only business records that can be reasonably relied upon to establish its taxable sales. Appellant asserts that its SUTRs, which were prepared from the accurate POS data, correctly reported taxable sales. Appellant has not provided any other evidence of these erroneous entries, such as transaction-level POS data to confirm the accuracy of the summaries and general ledger data showing the duplicate data transfers, stating that its accounting software was corrupted in 2016 and that none of the general ledger data can be retrieved.

At one point, appellant argued that the tip ratio used by respondent (15 percent) in its verification test was too low. Appellant's president (at the time) argued that tips averaged 20 to 22.5 percent. However, in a later brief, appellant states that the 15 percent tip ratio was reasonable, but it argues that the 85 percent credit card sales ratio used by respondent was too

[12] A taxpayer need not always prove that respondent's determination is wrong. For example, respondent may carry its minimal burden of proof by showing that its determined measure of unreported taxable sales is reasonably accurate, but a taxpayer may overcome the presumption in favor of that determination by proving a more accurate measure.

[13] According to appellant, it did not discover the errors until much later, when it learned that the bookkeeper had not only been making erroneous ledger entries, and ignoring other bookkeeping responsibilities, but had also been stealing money.

low, claiming that it could not have been less than 95 percent at any time.[14] Appellant has provided its documentation of various analyses purporting to show that respondent's determination is overstated. One of these analyses indicates possible underreporting of taxable sales of approximately $483,535 for the liability period.[15] The other merely acknowledges differences between appellant's taxable sales recorded and taxable sales reported, argues that appellant overreported taxable sales in some quarters, and notes that it cannot explain substantial differences for two quarters totaling $1,088,601.[16]

The essence of this part of appellant's argument is that the determination is wrong because it is based on appellant's general ledger, which appellant alleges is wrong. Appellant concedes that it has no business records with which it can prove the general ledger is wrong, and it claims that the evidence it might have used to prove its assertions was corrupted and lost forever, leaving the POS summaries, the records that reconcile with appellant's SUTRs, as the only records upon which a determination can be based. As explained below, this argument is unpersuasive.

The first question is whether appellant has successfully impeached the accuracy of its general ledger. Its effort to do so is based solely on unsupported assertions. The evidence does not prove a single error in the general ledger, and appellant's assertions about a dishonest bookkeeper and corrupted records are not persuasive. Logic suggests that a bookkeeper who was intent on theft would manipulate the books to show less income, not more. It is also difficult to understand why a bookkeeper would add phantom income to the general ledger but leave the POS data intact, and why appellant's president, the person who was apparently responsible for the financial management of the business, would not have discovered such manipulation when the general ledger first failed to reconcile with the POS data. Appellant has provided no credible evidence to explain the events or support its arguments. Appellant also has not provided evidence to explain the circumstances surrounding the claimed corruption of general ledger files.

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[14] Appellant made this argument though its current representative.

[15] This was appellant's president's estimate.

[16] In this analysis, provided by appellant's current representative, appellant asserts that it overreported taxable sales by between $35,997 and $125,979 for three of the nine quarters at issue, and underreported taxable sales by between $32,135 and $723,254 for the other six quarters at issue. Appellant asserts that four quarters of underreporting are explainable as timing differences.

It has not explained why records that were so obviously important to proving appellant's accurate tax liability were not backed up or otherwise protected from loss, or what appellant did to recover the data. In short, appellant has failed to impeach its general ledger. Furthermore, it has failed to show that the POS summaries are more accurate than the general ledger. The evidence suggests just the opposite, and the fact that the POS summaries reconcile with SUTRs does not prove the POS summaries are accurate. (See *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 617.) The POS summaries are not supported by detailed sales data, and they do not account for the substantial difference between total sales reported on SUTRs and gross receipts reported on FITRs ($962,301 for 2012 alone). The presumption in favor of the accuracy of respondent's determination remains.

The next question is whether appellant has proved that using a different method of calculating taxable sales will lead to a more reliable result and one favorable to appellant. Respondent's determination is based on a direct audit method that compared recorded and reported taxable sales. Appellant proposes that a more accurate calculation of its liability can and should be based on the POS summaries, which we have already found to be unsupported and unreliable, or on tip or credit card sales ratios that have no credible support in the record. Consequently, appellant has failed to carry its burden of proving a taxable measure more accurate than that determined by respondent.

In summary, appellant has not shown error in respondent's analysis; it has not established that the POS summaries upon which it relies are more reliable than the general ledger data upon which respondent relies; and it has not proved a taxable measure more accurate than that determined by respondent. Consequently, a further reduction to the measure of unreported taxable sales is not warranted.

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.) Although the term "negligence" in not specifically defined in the Sales and Use Tax Law, it is a common legal concept and is generally defined as a failure to act as a reasonably prudent person would have acted under similar circumstances. (*Acqua Vista Homeowners Assn. v. MWI, Inc.* (2017) 7 Cal. App. 5th 1129, 1157.) 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 keep complete and accurate records is evidence of negligence and may result in imposition of a negligence penalty. (Cal. Code Regs., tit. 18, § 1698(k).) 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.)

Initially, appellant argued that its POS reports accurately reflected its sales and that it reasonably relied on those records to report its sales to respondent. More recently, appellant has argued that, even if there was an understatement, it was far less than the determined measure; it was only for two of the nine quarters at issue; and it was due to "clerical error." Finally, appellant argues that its reliance on professional advisors to accurately complete its tax returns is reasonable cause to waive the negligence penalty.

Respondent established the entire understatement at issue here by comparing the amounts of taxable sales recorded in appellant's general ledger with the amounts of taxable sales reported on appellant's SUTRs.[17] The comparison showed that appellant underreported taxable sales in every quarter of the liability period by between $123,366 (for 2Q12) and $466,076 (for 4Q12). Appellant was not aware of the substantial discrepancy between its general ledger and its POS data until after the liability period.[18] A reasonably prudent businessperson monitors the financial health of the business. Discrepancies between the general ledger and the POS summaries, at least discrepancies like these, would have been apparent to appellant long before appellant filed

[17] Although appellant asserts that the only data available is from its POS system, that is not correct. Respondent scheduled data from appellant's general ledger, and appellant does not argue that respondent inaccurately scheduled the general ledger data.

[18] Appellant's president states in appellant's opening brief that appellant did not discover the discrepancies until it discovered that the bookkeeper was stealing money. Although appellant's president does not say when this discovery occurred, we infer that the discovery put an end to the discrepancies, and those occurred throughout the liability period. This inference is also supported by the fact that there is nothing in the audit work papers that indicates appellant's president ever mentioned a possible discrepancy when he provided the general ledger documents to respondent in 2014.

its SUTR for the first quarter at issue. Once such discrepancies were discovered, a reasonably prudent businessperson who was exercising due care would have taken immediate action to identify the cause of the discrepancy and to correct it; thereafter, that same reasonably prudent businessperson would have kept a watchful eye on the situation to make sure the error was not repeated. There is no evidence that appellant took any of these reasonable steps to better ensure that it was accurately reporting its taxable sales. Had appellant taken these steps, it likely would have discovered the discrepancy and the fact that it was reporting far more in gross receipts on its FITRs than it was reporting in total sales on its SUTRs.

If appellant had been diligently monitoring its finances, it also would have discovered early on – if it did not already know – that it had not deposited cash receipts since at least some time in April 2011. If appellant's bookkeeping was being handled by someone who was stealing money, as appellant has alleged, the absence of cash deposits would have been a red flag that at least demanded careful scrutiny. A careful look at the bank records also would have revealed that appellant's SUTRs for 2Q12 and 3Q12 reported less in taxable sales than the credit card sales receipts that were deposited into its bank account.[19] That would have been a clear indication to appellant that it was not reporting its taxable sales accurately. Finally, to the extent appellant argues that the general ledger upon which the determination is based was inaccurate and unreliable, appellant did not provide source documents, such as guest receipts or transaction-level POS data, with which the accuracy of its POS summaries might have been tested.[20] All of this evidence demonstrates appellant's lack of due care in its maintenance of complete and accurate records.

Finally, the evidence also shows that, in addition to failing to exercise ordinary and reasonable care to maintain and provide complete and accurate records, appellant relied (or claims to have relied) on records that were inaccurate, which caused it to substantially underreport its taxable sales. The ratio of underreported taxable sales to reported taxable sales is

[19] Credit card sales deposits (excluding tax and tips) during 2Q12 and 3Q12 totaled $1,176,175 and $1,025,721, respectively, but appellant reported gross sales of $1,157,944 and $413,958 for those quarters.

[20] Regarding the claimed corruption and loss of the general ledger data, a reasonably prudent businessperson takes steps to ensure that important financial records are not lost or destroyed through human error or equipment failure. The evidence does not show what appellant did to protect, back up, or recover its data.

21.43 percent ($2,220,887 ÷ $10,360,741 = .21435). That ratio is significant and sufficient to support respondent's imposition of the penalty.

As already discussed above, appellant's arguments against a finding of negligence are in large part based on unsupported assumptions regarding average tips and the credit card sales ratio. Respondent used the numbers provided by appellant's president and appellant has not shown any error in that regard. Also, if by "clerical error" appellant asserts that the substantial and consistent underreporting was due to an innocent mistake by a low-level employee, this would be inconsistent with appellant's argument that the underreporting was due to the neglect of and theft by a former bookkeeper. It would also lack any evidentiary support and be a mischaracterization of what the evidence proves.

Finally, there is no factual or legal support for appellant's claim that its reliance on professional advisors to accurately complete its tax returns is reasonable cause to waive the negligence penalty. Regardless of whether a tax professional prepared and filed appellant's returns, there is abundant evidence that appellant was negligent. Moreover, OTA does not have the authority to "waive" a negligence penalty.[21] OTA reviews the evidence to determine whether or not the penalty was correctly imposed, that is, whether the evidence, including evidence of reliance on tax professionals, proves that a taxpayer was negligent. If the evidence does not prove negligence, the penalty is overruled. If the evidence proves negligence, the penalty stands, and OTA cannot compel respondent to waive a negligence penalty that is supported by the evidence. Here, negligence is clear and respondent correctly imposed the penalty.

[21] Unlike some other penalties (see, for example, R&TC section 6597), there is no authority for abating a negligence penalty on reasonable cause grounds. Those concepts are mutually exclusive. A negligence penalty is imposed when a taxpayer fails to act reasonably. There can be no reasonable cause for an unreasonable act or omission.

HOLDINGS

1. A further reduction to the amount of unreported taxable sales is not warranted.
2. Respondent correctly imposed the negligence penalty.

DISPOSITION

Respondent's Decision reducing the taxable measure to $2,220,887, but otherwise denying the petition, is sustained.

DocuSigned by:
Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
Natasha Ralston
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Natasha Ralston
Administrative Law Judge

DocuSigned by:
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Date Issued: 8/15/2022