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2022 – OTA – 370
Nonprecedential

**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

| In the Matter of the Appeal of: | ) OTA Case No. 21129287 |
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| **LUOSQ, LLC** | ) CDTFA Case ID 1-565-137 |
| **dba China Buffet** | ) |

**OPINION**

Representing the Parties:

For Appellant: Hong Ye, CPA

For Respondent: Nalan Samarawickrema, Hearing Representative
Kevin Smith, Tax Counsel III
Jason Parker, Chief of Headquarters Operations

For Office of Tax Appeals: Richard Zellmer
Business Tax Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Luosq, LLC (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA),[1] partially denying appellant's petition for redetermination of the Notice of Determination (NOD) for tax of $232,748, a negligence penalty of $23,274.84, and applicable interest, for the period April 1, 2015, through December 31, 2018 (audit period). In its decision, CDTFA reduced the understated measure of tax from $1,799,760 to $1,214,877, which will result in reductions to the tax and penalty. CDTFA denied the remainder of the petitioned amount.

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of BOE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE; and when referring to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

Office of Tax Appeals Administrative Law Judges Josh Aldrich, Andrew J. Kwee, and Keith T. Long held an electronic oral hearing for this matter on July 26, 2022. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

## ISSUES

1. Whether appellant has shown that any further reduction to the amount of unreported taxable sales is warranted.
2. Whether appellant was negligent.

## FACTUAL FINDINGS

1. Appellant operated a buffet style restaurant serving Chinese food. Appellant's menu included a weekday lunch buffet for $8.99 plus tax, a dinner buffet for $12.99 plus tax, a weekend lunch buffet for $12.99 plus tax, and drinks for $1.65 plus tax.
2. CDTFA audited appellant for the period April 1, 2015, through December 31, 2018. For the audit period, appellant reported total sales and taxable sales on its sales and use tax returns of $2,597,180, claiming no deductions. Appellant informed CDTFA that guest checks were used to record daily sales in its sales journal, which was in turn used to prepare the sales and use tax returns.
3. Upon audit, appellant provided federal income tax returns for 2015, 2016, and 2017; and bank statements and monthly sales journals for the period January 2015 through December 2017. Appellant did not provide sales journals for 2018. Appellant did not provide guest checks for audit until after CDTFA made a specific request that appellant save its guest checks for September 2018. Appellant then provided some of those guest checks for audit.
4. CDTFA found no differences between the gross receipts that appellant reported on its federal income tax returns and the total sales reported on appellant's sales and use tax returns. CDTFA computed book markups[2] by comparing reported total sales to reported

[2] "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 (.30 ÷ 1.00 = 0.3).

cost of goods sold (COGS) but found that these markups were unreliable because the COGS reported on appellant's federal income tax returns could not be verified.

5. CDTFA determined that 80.23 percent of appellant's bank deposits were made by credit card. CDTFA expected credit card deposits to be in the range of 40 to 60 percent of total sales for this buffet-style restaurant, and thus, CDTFA found the 80.23 percent credit-card-deposit-ratio to be too high for appellant's business.

6. CDTFA planned to use appellant's September 2018 guest checks to compute a ratio of sales paid for with credit cards to total sales (the credit-card-sales-ratio).[3] CDTFA made two unannounced visits to appellant's business, including: on Wednesday, September 12, 2018, during lunch time, from 12:20 p.m. to 1:30 p.m.; and on Saturday, September 22, 2018, during dinner hours, from 6:30 p.m. to 8:15 p.m.
    a. During the September 12 visit, CDTFA purchased a meal and was given guest check number 34841 for the purchase. CDTFA observed total sales (including sales tax reimbursement) of $370.15, including cash sales of $254.50, and credit card sales of $115.65. The observed sales resulted in a credit-card-sales-ratio of 31.24 percent ($115.65 ÷ $370.15).
    b. During the September 22 visit, CDTFA purchased a meal and was given guest check number 32721 for the purchase. CDTFA observed total sales (including sales tax reimbursement) of $475.00, including cash sales of $241.50, and credit card sales of $233.35 was paid with credit cards. The observed sales resulted in a credit-card-sales-ratio of 49.13 percent ($233.35 ÷ $475.00).

At the end of September 2018, CDTFA examined the provided guest checks, and the provided guest checks included a complete set of documentation for a series, which started at 13001 and ended at 14674. Nevertheless, CDTFA found that the two guest checks for CDTFA's purchases (numbers 34841 and 32721) were not included with or part of the same series as the guest checks provided by appellant. Thus, CDTFA found

[3] Generally, the credit-card-sales-ratio method involves calculating the ratio of credit card sales to total sales (the credit-card-sales-ratio) and dividing credit card sales by that ratio to compute audited sales.

the provided guest checks for September 2018 incomplete, and not usable for testing purposes.[4]

7. CDTFA contacted appellant during October 2018 to schedule a 3-day observation test, which would be used to compute a credit-card-sales-ratio.[5] However, the 3-day observation test was never performed because appellant requested that the observation test be delayed from October 2018 until November 2019, and thereafter closed the business in November 2018.[6]

8. CDTFA calculated an audited credit-card-sales-ratio of 40.19 percent by averaging the 31.24 percent credit-card ratio observed on September 12, 2018, and the 49.13 percent credit-card-sales-ratio observed on September 22, 2018. CDTFA used this credit-card-sales-ratio to compute unreported taxable sales of $1,799,760 in the original audit.[7]

9. CDTFA issued an NOD to appellant on August 23, 2019, for tax of $232,748.00, a negligence penalty of $23,274.84, and applicable interest, for the period April 1, 2015, through December 31, 2018, based on the audit. Appellant filed a timely petition for redetermination of the NOD.

10. In a December 14, 2020 decision, CDTFA found that the credit-card-sales-ratio produced an unreasonable result because it resulted in average daily sales of $3,793.70, which is significantly higher than the average observed daily sales of $2,777.92[8] that CDTFA computed from the observation test. Based on this, CDTFA ordered that a reaudit be

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[4] At the oral hearing, OTA provided appellant an opportunity to explain this discrepancy, and appellant responded by conceding that the guest checks it provided to CDTFA were incomplete.

[5] An observation test is the physical observation of the business by a CDTFA auditor for the purpose of recording sales information.

[6] According to notes recorded in CDTFA's audit working papers, CDTFA contacted appellant in October to schedule additional observation tests. Appellant did not respond until October 29, 2018, during which time appellant's representative stated they would be out of the country until November 2019. Appellant closed the business approximately one month after this telephone call.

[7] OTA does not provide the details of this calculation because CDTFA later changed its audit method.

[8] On September 12, 2018, CDTFA observed approximately $370.00 of sales in 70 minutes, which equates to $317.14 per hour ($370 ÷ 70 minutes x 60 minutes), which in turn equates to $1,427.13 per day for the 4.5 hour lunch period ($317.14 x 4.5 hours). On September 22, 2018, CDTFA observed approximately $475.00 of sales during a 105 minute observation during dinner hours, which equates to $271.43 per hour ($475.00 ÷ 105 minutes x 60 minutes), which in turn equates to $1,628.58 per day for the 6 hour dinner period ($271.43 x 6 hours). $1,427.13 + $1,628.58 = $3,055.71. This amount was reduced by 10 percent to account for sales tax reimbursement to compute average daily sales, excluding tax and tips, of $2,777.92 per day. CDTFA later agreed to a 10.25 percent reduction, because the tax rate was 10.25 percent.

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performed to compute unreported taxable sales based on average daily sales of $2,777.92, and otherwise denied appellant's petition.

11. CDTFA prepared a first reaudit. CDTFA multiplied average daily sales of $2,777.92 by 1,309 days the business was open during the audit period,[9] to compute audited taxable sales of $3,636,300.00 for the audit period. The audited taxable sales of $3,636,300.00 was compared to reported taxable sales to compute unreported taxable sales of $1,222,429.00 (as compared to unreported taxable sales of $1,799,760.00 computed in the original audit).
12. Appellant filed a timely request for reconsideration of CDTFA's decision. On November 12, 2021, CDTFA issued a supplemental decision, finding that no further adjustments were warranted and ordering that the measure of tax be reduced to $1,222,429 as calculated in the first reaudit.
13. Appellant filed the instant appeal with OTA.
14. During this appeal, CDTFA determined that the calculation of daily sales of $2,777.92 did not take into consideration the correct tax rate of 10.25 percent. CDTFA performed a second reaudit, reducing average daily sales of $3,055.71 by 10.25 percent (instead of 10 percent) to compute average daily taxable sales of $2,772.15. CDTFA multiplied the average daily taxable sales of $2,772.15 by 1,309 days the business was open during the audit period, to compute audited taxable sales of $3,628,748 for the audit period. CDTFA compared audited taxable sales to reported taxable sales to compute unreported taxable sales of $1,214,877. CDTFA now states that the taxable measure should be reduced to $1,214,877, and that the petition should be otherwise denied.[10]

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[9] CDTFA did not include December 2018 in this calculation because appellant closed the business in November 2018.

[10] CDTFA also noted that tips were not accounted for in the taxable measure. Tips are not at issue in this appeal. We note that CDTFA's average daily sales amount of $2,772.15 was calculated using figures that already did not include tips; thus, no adjustment is warranted or allowable for non-taxable tips.

## DISCUSSION

Issue 1: Whether appellant has shown that any further reduction to the unreported taxable sales is 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, unless the retailer can prove otherwise. (R&TC, § 6091.) Although gross receipts from the sale of "food products" are generally exempt from the sales tax, sales of hot food and sales of food served in a restaurant are subject to tax. (R&TC, § 6359, (a), (d)(1), (d)(2), and (d)(7).)

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. (*Id.*) That means that the taxpayer must prove both: (1) the tax assessment is incorrect, and (2) the correct amount of the tax. (*Appeal of AMG Care Collective*, 2020-OTA173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Id.*)

Here, appellant did not provide a complete set of books and records. To calculate the taxable measure, CDTFA made two observations, from which average daily sales were calculated. During the second reaudit, CDTFA reduced the average daily sales by the sales tax rate and multiplied the result by the number of days that the business was open. When compared to appellant's reported taxable sales, CDTFA's calculations revealed a discrepancy, which appellant could not explain.

OTA recognizes that CDTFA's approximately 2.5 hours of observations require additional scrutiny because it is far less than the minimum time established by CDTFA Audit Manual section 0810.30, which now recommends at least three full observation days for

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projection purposes.[11] However, as described above, CDTFA was left with few options. Appellant did not provide a complete set of books and records for the audit. And the records that appellant did provide were unverifiable or unreliable. For example, CDTFA could not verify the COGS recorded on appellant's federal income tax returns. Appellant also failed to provide a complete set of its guest checks for September 2018, as requested by CDTFA. Thus, given the lack of books and records, it was reasonable for CDTFA to perform an observation test to project appellant's taxable sales.

As to whether the observation test could have been longer, it was appellant that prevented CDTFA's expansion of the observation test. First, appellant postponed the observation test. Then appellant closed the business. As a result, a three-day observation test was not possible. When considered with the fact that CDTFA initially used a different audit method, which resulted in a significantly larger deficiency, we find that it was reasonable for CDTFA to base the taxable measure on the information obtained during its two observations. Thus, we find that CDTFA has met its initial burden to show that its determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to show errors in the audit. (*Appeal of Talavera, supra*)

On appeal, appellant asserts that the audit method is flawed. Specifically, appellant asserts that the observations were done during peak times. Appellant asserts that the audited average daily sales of $2,227.15 is excessive because it does not take into account lower sales during non-peak hours. Appellant asserts that sales during non-peak hours are half the amount of sales during peak hours. As discussed above, OTA finds that the audit method is both reasonable and rational. Accordingly, appellant is required to provide documentation to show that a reduction is required. (*Id.*) However, appellant has not provided documentation to establish when its peak hours were. Appellant also has not provided documentation to show that the amount of sales during non-peak hours are half of the amount of sales during peak hours, or otherwise show the amount of sales during non-peak hours.

Similarly, appellant contends that the Saturday, September 22, 2018 observation is unreasonable because, as one of its busiest days, the Saturday observation results in an excessive amount of average daily sales. However, a comparison of the two observation days reveal that

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[11] CDTFA's Audit Manual does not provide binding legal authority; however, OTA may look to it for guidance. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

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the Saturday observation resulted in average sales of $271.43 per hour, but the Wednesday, September 12, 2018 observation resulted in sale of $317.14 per hour (approximately $50 more). Appellant has not offered an explanation for this contradiction. Appellant also has not provided any reliable documentation to show that Saturday sales are typically greater than other days. Finally, appellant has not provided documentation that could be used to compute a more accurate amount of average daily sales.

Finally, appellant contends that the calculation of the $2,227.15 amount does not take into consideration tips, which are not subject to tax. However, the $2,227.15 amount was calculated exclusively from data which already excluded tips. CDTFA calculated this amount by multiplying the applicable tax-included buffet price[12] by the number of people observed ordering a buffet and added the number of drinks observed ordered multiplied by the tax-included drink sales price. CDTFA then divided by 1.1025, to calculate the average sales amount exclusive of tax. CDTFA then projected the daily sales amount by multiplying the hourly observed sales by the number of hours of operation on each observation day. In other words, no tip amounts were included in the calculation of the average daily sales. Therefore, as a matter of law, no deduction for tips is allowable. Thus, we conclude that additional reductions to the measure of unreported taxable sales are not warranted.

Issue 2. Whether appellant was negligent.

CDTFA states that it imposed the negligence penalty provided by R&TC section 6484 because appellant substantially under-reported its taxable sales, and because appellant did not maintain complete books and records. Appellant contests the negligence penalty but provides no specific reasons.

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. (*Warner v. Santa Catalina Island*

[12] The rate for children differed from the rate for adults.

*Co.* (1955) 44 Cal.2d. 310, 317; see also *People v. Superior Court (Sokolich)* (2016) 248 Cal. App. 4th 434, 447.)

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).)

California Code of Regulations, title 18, section 1703(c)(3)(A) provides that a negligence penalty should not be added to a deficiency determination associated with the first audit of a taxpayer in the absence of evidence establishing that any bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the sales and use tax law or authorized regulations. (See also; *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318,321-324.) In the case at hand, appellant had not been previously audited.

The understatement of $1,214,877 represents an error ratio of 46.8 percent when compared to reported taxable sales of $2,597,180 ($1,214,877 ÷ $2,597,180). We find that the large size of the understatement and the size of the error ratio are evidence of negligence in reporting.

Appellant did not provide sales journals for 2018. Appellant's guest checks were the basis for recorded and reported sales, yet appellant did not provide any guest checks at all for 44 of the 45 months of the audit period. CDTFA specifically directed appellant to save its guest checks for September 2018. Appellant knew the guest checks for September 2018 were to be used in an audit test, and thus knew the importance of saving those guest checks. Yet appellant only provided one sequentially complete set of records for its guest checks for that month, although it is undisputed that appellant maintained more than one sequential set of records for its

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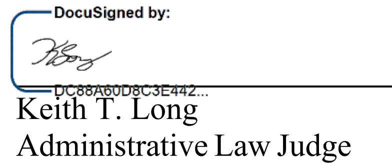
guest checks. We find that this level of negligence in recordkeeping cannot be attributed to appellant's good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the sales and use tax law or authorized regulations. (See also; *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318,321-324.)

## HOLDINGS

1. Appellant has not shown that further reductions to the measure of tax are warranted.
2. Appellant was negligent.

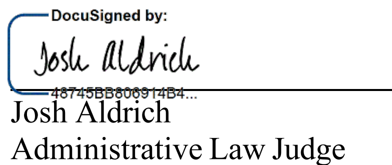
## DISPOSITION

CDTFA's action in reducing the measure of tax to $1,214,877 and otherwise denying the petition is sustained.

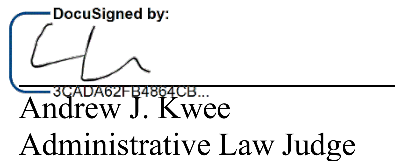



Keith T. Long
Administrative Law Judge

We concur:




Josh Aldrich
Administrative Law Judge




Andrew J. Kwee
Administrative Law Judge

Date Issued: 8/29/2022