OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19125557
	) CDTFA Case ID 137-088
HUFF FOODS, LLC	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant	Anna M. Huff, Owner
For Respondent:	Nalan Samarawickrema, Hearing Representative Chad Bacchus, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Huff Foods, LLC (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) dated April 20, 2017. The NOD is for tax of $61,153.59, applicable interest, and a negligence penalty of $6,115.40, for the period January 1, 2014, through June 30, 2016 (audit period). Subsequently, CDTFA timely notified appellant of an increase in the determined amount of tax to $65,965, with a corresponding increase in the 10 percent penalty, to $6,596.48.

Office of Tax Appeals (OTA) Administrative Law Judges Teresa A. Stanley, Andrew J. Kwee, and Keith T. Long held an oral hearing for this matter in Sacramento,

[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 this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE; and when this Opinion refers to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

California, on October 20, 2022. At the conclusion of the hearing, the record was closed and this matter was submitted for an Opinion.

ISSUES

1. Whether appellant has shown that adjustments are warranted to the audited understatement of reported taxable sales.
2. Whether the understatement was the result of negligence.

FACTUAL FINDINGS

1. Appellant began operating a franchise restaurant, doing business as Salad Farm, selling various hot and cold food items and beverages, including draft beer, beginning in April 2013. CDTFA closed appellant's seller's permit effective June 30, 2016, but the parties agree that the business stopped making sales in the first quarter of 2016 (1Q16).[2]
2. During the audit period, appellant reported total sales and taxable sales of $61,476, claiming no deductions.
3. CDTFA obtained menu and restaurant information from Yelp.com (Yelp)[3] showing that appellant sold various hot and cold food items and beverages, including draft beer. Appellant also collected sales tax reimbursement. CDTFA contacted appellant regarding an audit but did not receive a response. Appellant did not provide books and records for the audit.
4. CDTFA obtained 1099-K forms,[4] which it used to establish the electronic payments to appellant (referred to herein as "credit card payments"[5]) of $449,723 for the years 2014 and 2015. After a 13 percent reduction for tips and a 9 percent reduction for tax included

[2] CDTFA closed appellant's seller's permit effective June 30, 2016. However, appellant's bank account statements show no deposits after February 2016. Hence, the agreement that sales ended in 1Q16.

[3] Yelp.com is a website that allows users to leave business and service reviews.

[4] Form 1099-K is an Internal Revenue Service form titled, "Payment Card and Third Party Network Transactions," which shows the monthly and annual amounts paid to a merchant by a bank, credit card company, or third party network, during a given time period. Form 1099-K includes payments made my any electronic means, including but not limited to credit cards, debit cards, and PayPal.

[5] We will use the term "credit card payment," which is the most common electronic payment method in restaurants, although the electronic payments received by the restaurant may have also included payments by debit card or other electronic payments.

in the total, this amounts to audited credit card payments of $365,122. During that same period, appellant reported taxable sales of $60,587.

5. CDTFA divided the audited credit card payments for each quarter of 2014 and 2015 by an estimated credit card sales to total sales ratio of 50 percent and computed audited taxable sales of $730,244, which exceeds appellant's reported taxable sales for the two years by $669,657. CDTFA computed percentages of error for each quarter of 2014 and 2015, and an error rate of 1,105.28 percent for the two years combined, which when applied to reported taxable sales of $889 for 1Q16 reveals an understatement of $9,826 for that quarter. In total the audited understatement of reported taxable sales was $679,483 ($669,657 + $9,826).
6. On April 20, 2017, CDTFA issued an NOD for tax of $61,153.59. CDTFA also imposed a negligence penalty of $6,115.40.
7. On May 1, 2017, appellant filed a petition for redetermination. Appellant then provided the following records to CDTFA: a Call History Record of a burglary at the restaurant on February 28, 2016;[6] a federal income tax return for 2013;[7] and bank statements for the period January 1, 2014, through June 30, 2016. Appellant asserted that it could not provide Point of Sale (POS) records because its computer had been destroyed during the burglary in February 2016.
8. In a reaudit, CDTFA compiled appellant's bank deposits totaling $865,910 from the bank statements and reduced the amounts for each quarter by the amounts of sales tax included,[8] to compute audited taxable sales, net of tax, of $794,413, which when compared to reported taxable sales of $61,476, reflects a difference of $732,937.

[6] Appellant has provided a call history record that confirms a broken window at the business but also states "appears no entry was made." Without further contemporary evidence to corroborate appellant's contentions, such as a police report, we cannot conclude that appellant's computer was stolen or destroyed.

[7] According to CDTFA's Decision, appellant confirmed that 2013 (erroneously typed as 2014 in the Decision) was the only year for which a federal income tax return had been filed.

[8] CDTFA did not reduce the amounts of bank deposits by an estimated amount of tips. The record does not include CDTFA's reasoning for not making an adjustment for tips, while it had made that adjustment in the audit, which had been completed using the credit card ratio audit method. However, when tips are paid by credit card, it is common for a restaurant to take cash from the register to pay servers for tips charged on credit cards. In that situation, the cash from the tip is not deposited in the bank, and an adjustment to bank deposits for tips included therein would not be appropriate. Appellant has not alleged it deposited credit card tips.

9. On November 30, 2018, CDTFA issued a notice of increase[9] to appellant explaining that the tax and penalty had been increased by $4,811.41 and $481.08, respectively.
10. On November 6, 2019, CDTFA issued a Decision denying the petition for redetermination. On April 15, 2021, CDTFA issued a Notice of Redetermination for tax of $65,965.00 and a negligence penalty of $6,596.48.
11. On December 4, 2019, OTA received appellant's timely appeal in this matter.

DISCUSSION

Issue 1: Whether appellant has shown that adjustments are warranted to the audited understatement of reported taxable sales.

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*.)

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

[9] CDTFA was authorized to increase the liability because the determination was not final, and the notice of increase mailed to appellant was timely issued (it was issued less than three years from the date of the NOD). (R&TC, § 6563.)

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, which we refer to 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).)

When a right to an exemption from tax is involved, the taxpayer has the burden of proving its right to the exemption. (*H. J. Heinz Company v. State Board of Equalization* (1962) 209 Cal.App.2d 1, 4.) Any taxpayer seeking exemption from the tax must establish that right by the evidence specified by the relevant regulation. A mere allegation that sales are exempt is insufficient. (*Paine v. State Board of Equalization* (1982) 137 Cal.App.3d 438, 442.)

When CDTFA cannot compute taxable sales from appellant's records, it is appropriate to use an indirect audit approach to calculate the taxable measure. (See *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.) Here, appellant did not provide any records for the audit. To calculate the taxable measure in the audit, CDTFA used the credit card payment information recorded in appellant's forms 1099-K information to estimate appellant's taxable sales. CDTFA also relied on information from an internet source (Yelp) to determine the nature of appellant's business and to conclude that appellant's sales fit within the provisions of the 80/80 rule and that all its sales were subject to tax. Considering the complete lack of books and records from appellant, it was reasonable for CDTFA to use a credit card ratio to calculate the audit measure.

For the reaudit, appellant provided evidence of a February 2016 burglary; a federal income tax return for 2013 (the year before the audit period); and bank statements for the audit period. CDTFA used the deposits recorded on appellant's bank statements to establish audited taxable sales. When compared to appellant's reported taxable sales, appellant's bank deposits revealed a deficiency. Considering the foregoing, we find that it was reasonable for CDTFA to use appellant's bank statements to calculate appellant's audited taxable sales. Accordingly, the burden of proof shifts to appellant to show that adjustments are warranted. (*Appeal of Talavera*, *supra*.)

On appeal, appellant argues that the taxable measure should be reduced for several reasons. Appellant argues that more than one audit method should have been used in determining the deficiency measure. Appellant asserts that the audit is based solely on the bank deposit analysis. On that issue, CDTFA's Audit Manual,[10] section 0407.05 lists various indirect audit methods that may be used when sales cannot be verified by a direct audit approach. That section states, "If enough information is available to do so, the auditor should use two or more of these methods to estimate the sales, comparing the results of one method against the results of another." As discussed above, CDTFA reasonably and rationally used the available books and records (i.e., appellant's bank statements) to determine the deficiency measure. Nevertheless, the OTA notes that CDTFA also completed a credit card analysis based on appellant's forms 1099-K which produced similar results. Thus, appellant's contentions with respect to whether CDTFA should have used a second audit method are without merit.

Next, appellant argues that its bank statements include non-sale deposits from loans received totaling $145,068. Here, OTA reviewed appellant's bank statements for the liability period and found that on January 7, 2016, funds of $6,701 were deposited into appellant's bank account from EBF Partners (EBF). Thereafter, appellant made regular payments to EBF. We find this to be compelling evidence that appellant received a non-sale deposit of $6,701 from EBF. On February 18, 2016, funds of $8,780 were deposited into appellant's bank account from Funding Metrics. Based on this, OTA finds that it is more likely than not that appellant received a loan from Funding Metrics during the audit period. Accordingly, appellant's bank deposits, which were used to determine audited taxable sales, must be reduced by non-sale deposits of $15,481 ($6,701 + $8,780).

Appellant's bank statements also revealed a deposit from "Bofi Federal Ban," (Bofi) in the amount of $19,500. CDTFA's audit workpapers reference this payment specifically, stating that the nature of the deposit needs to be verified. OTA agrees. Appellant has not provided any explanation or support from which we can determine the nature of this deposit. For example, without further information it cannot be determined whether this deposit is from a loan or other bank transfer. OTA also did not find any payments made to Bofi during the audit period.

[10] 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.)

Similarly, appellant made payments to both Ondeck Capital and Quickfix Capital. At the appeals hearing, appellant asserted that it received loans from these companies. However, there are no corresponding deposits from these lenders. Without further evidence (such as loan documents), OTA cannot determine whether these amounts were payments for a loan, if any such loans were deposited in appellant's bank account during the liability period, if such loans were received in a form such as cash, or if such loans were deposited elsewhere. Therefore, OTA finds that additional reductions are not warranted based on alleged loan receipts.

Appellant also provided revised sales and use tax returns for the audit period, which it claims to be more accurate. Despite these claims, appellant has not provided source documents to support the figures recorded on the revised returns. Indeed, appellant states that its books and records were destroyed during a 2016 burglary. Without books and records available, it is unclear how appellant derived the figures contained within the revised sales and use tax returns.

There are also discrepancies within the revised returns that appellant has not explained. For example, the revised returns assert total sales of $740,994 and claimed nontaxable sales of $674,452, the difference of which should result in taxable sales of $66,542. However, the revised returns assert taxable sales of only $64,051. OTA notes that both the asserted revised taxable sales and corrected figure are greater than appellant's reported taxable sales for the audit period. Nevertheless, appellant has not conceded to underreporting any taxable sales. Finally, when considered together, appellant's asserted revised total sales of $740,994[11] and appellant's asserted loan receipts of $145,068 equal $886,062, which is $20,152 more than appellant deposited in the bank during the audit period. At the appeals hearing, appellant asserted that it received some loans in cash, which was not deposited into the bank. However, there is no evidence to support this contention. These discrepancies are further evidence that appellant's revised sales and use tax returns are unreliable.

Next, appellant argues that the measure of nontaxable sales should be increased. Appellant contends that at least 80 percent of its sales were sales of food "to go" and at least 80 percent of its sales were sales of cold food products. Appellant explains that customers selected from a variety of ingredients, which included meats such as grilled steak, chicken, salmon, or seared tuna, but also included a wide variety of cold ingredients. Appellant asserts

[11] This amount does not include the amounts of sales tax reimbursement collected from customers, which would also be deposited in the bank.

that 80 percent of the customers were either vegetarian or vegan, and only about 20 percent of customers purchased salads with meat.

In support, appellant includes a copy of a different salad farm's menu. On that menu, we find 25 items that would likely be sold cold and 33 items that are either hot items (e.g., soup or baked potato) or salads sold with grilled meat or vegetables, which would be hot food for sales and use tax purposes. Thus, it appears that the majority of the menu items were hot food, and sales of those products would be taxable, whether they were sold for consumption on the premises or "to go." Also, CDTFA has provided evidence, from Yelp reviews, that appellant offered seating both inside and outside. As discussed above, all sales of food for consumption on the premises would be taxable, regardless of whether the food was cold or hot. Thus, it is clear that a significant percentage of appellant's sales would be taxable. On this issue, we emphasize that all sales of hot food are subject to sales and use tax, and all sales of cold food to be consumed in the restaurant are subject to sales and use tax. Accordingly, the fact that appellant may have sold a substantial amount of cold food does not, by itself, establish that a large percentage of its sales were exempt sales of cold food "*to go*."

Appellant offers percentage estimates of customers who did not consume meat, and it stresses that salads were the most popular menu items. Appellant's estimates are unsupported by any documentation. As discussed above, appellant asserts that its records were destroyed as a result of a 2016 burglary. In the absence of any reliable records, we cannot begin to establish a representative percentage of sales that were either sales of hot food or sales of food for consumption at the restaurant. However, if the percentage of appellant's sales of cold food "to go" was 20 percent or less of its total sales, all of appellant's sales would be subject to tax, as a result of the 80/80 rule, explained above. (Cal. Code Regs., tit. 18, § 1603(c)(3).) We find there is no basis to conclude that more than 20 percent of appellant's sales were exempt sales of food "to go."

Regarding appellant's request that CDTFA review sales made by other Salad Farm franchisees to establish a percentage of taxable to total sales, appellant is responsible to establish its right to an exemption by providing evidence (such as summary records supported by source documents). (*H. J. Heinz Company v. State Board of Equalization, supra;* and *Paine v. State Board of Equalization, supra*.) Appellant has failed to do so. Appellant has not met its burden of proof.

Issue 2: Whether the understatement was the result of negligence.

R&TC, section 6484 provides that if any part of the 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.

Taxpayers are required to maintain and make available for examination on request by CDTFA, or its authorized representative, 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 sales and use tax returns. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: (a) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (b) bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and (c) 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, including all bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account, will be considered evidence of negligence and may result in the imposition of penalties. (Cal Code Regs., tit. 18, § 1698(k).)

Generally, a penalty for negligence or intentional disregard should not be added to determinations associated with the first audit of a taxpayer. (Cal. Code Regs, tit. 18, § 1703(c)(3)(A).); also see *Independent Iron Works, Inc. v. State Bd. Of Equalization* (1959) 167Cal App.2d 318, 321-324.) However, a negligence penalty should be upheld in a first audit if the understatement cannot be attributed to a bona fide and reasonable belief that the bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. (*Ibid*.)

CDTFA concluded that the understatement was the result of negligence because appellant provided almost no records, and the audited understatement represented 1,192 percent of the amount of reported taxable sales ($732,937 ÷ $61,476). Appellant disputes the negligence penalty on the basis that its failure to provide adequate documentation was the result of the robbery in February 2016. Appellant has provided little evidence that a burglary occurred. It has not provided a police report, which would explain in more detail what items were stolen and what damage, if any, was done to the computer or documents. Even if the computer had been

stolen or destroyed, appellant has not provided a non-negligent explanation[12] for the complete absence of records that would not have been maintained on that computer (e.g., sales information from after the robbery took place, backups of computer data; printed financial documents, such as profit and loss statements; or purchase invoices). OTA finds there is ample evidence that appellant was negligent in record keeping.

During the audit period, appellant reported taxable sales of $61,476, which is less than 8 percent of the audited taxable sales of $794,413. This is further evidence that appellant was negligent. Appellant had not been audited previously, and a negligence penalty is not generally imposed on a first audit. However, considering the severe lack of records and the substantial amount of understatement, OTA finds that no reasonably prudent businessperson, regardless of his or her level of experience, could have held a good faith and reasonable belief that the record keeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or regulations. Thus, we find that the understatement was the result of negligence, and the penalty was properly applied. (Cal. Code Regs, tit. 18, § 1703(c)(3)(A); and *Independent Iron Works, Inc. v. State Bd. Of Equalization, supra.*)

[12] At the oral hearing, appellant asserted that after the 2016 burglary, it simply threw everything in the trash rather than retaining records.

HOLDINGS

1. Appellant has shown that adjustments are warranted to the audited understatement of reported taxable sales.
2. The understatement was the result of negligence.

DISPOSITION

Reduce the amount of bank deposits related to sales by non-sale deposits of $15,481, recompute audited taxable sales, and redetermine the tax accordingly. Reduce the negligence penalty in accordance with the reduction of tax. Otherwise, CDTFA's decision to deny the petition for redetermination is sustained.

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Keith T. Long
Administrative Law Judge

We concur:

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Teresa A. Stanley
Administrative Law Judge

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Andrew J. Kwee
Administrative Law Judge

Date Issued: 12/19/2022