OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **MAGPIE GRILL, INC.,** **dba Magpie Grill**	OTA Case No. 19034460 CDTFA Case ID 871435

OPINION

Representing the Parties:

For Appellant: Juan Guzman, CPA

For Respondent: Pamela Bergin, Assistant Chief Counsel

For Office of Tax Appeals: Casey Green, Tax Counsel III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Magpie Grill, Inc. (appellant) appeals a January 31, 2017 Decision and Recommendation (Decision) issued by California Department of Tax and Fee Administration (respondent)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated April 9, 2015.[2] The NOD was for $141,511.46 in tax, applicable interest, and a 40 percent penalty of $56,604.61 pursuant to R&TC section 6597 for failing to timely remit collected sales tax reimbursement (failure-to-remit penalty) for the period April 1, 2011, through March 31, 2014 (liability period).[3]

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

[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.

[2] The NOD was based on an audit that determined the deficiency measured by $1,582,874 in unreported taxable sales based on recorded versus reported sales tax.

[3] Because it is the retailer's obligation to pay sales tax after the quarter for which the tax is due, the retail customer, in effect, "reimburses" the retailer for the tax in advance.

ISSUES

1. Is appellant entitled to a reduction to the measure of unreported taxable sales?
2. Is appellant entitled to have all or any part of the failure-to-remit penalty abated or relieved?

FACTUAL FINDINGS

1. Appellant, a California corporation, operated two restaurants during the liability period. One was Mota's Mexican Restaurant (Mota's) in Altadena, a small neighborhood Mexican-style restaurant that opened in 2002.[4] Mota's used paper guest checks to record sales. The other restaurant was Magpie Grill (Magpie), a full-service restaurant in La Cañada Flintridge, which used an electronic point-of-sale (POS) system to record sales. Appellant incorporated in November 2006.
2. During the liability period, appellant filed returns on a quarterly prepay basis. The owner, Mr. Adolfo Alvarez Mota, prepared monthly sales summaries from Mota's guest checks and Magpie's POS data. These summaries contained only monthly sales totals for each restaurant. Mr. Mota used the monthly summaries to make prepayments. Appellant's accountant, its representative in this appeal, used the monthly summaries to prepare sales and use tax returns.
3. For the liability period, appellant reported total sales (from both restaurants) of $1,591,800 and claimed deductions of $130,399 for sales tax reimbursement included in reported total sales, resulting in reported taxable sales of $1,461,401: $1,149,500 from the sales by Magpie and $311,900 from the sales by Mota's.[5]
4. For the audit, appellant provided its 2011, 2012, and 2013 Federal Income Tax Returns (FITRs); sales and use tax returns and related worksheets, bank statements, monthly merchant statements, guest checks from Mota's for September 22, 2014, and September 26, 2014, and electronic sales data from Magpie's POS system.
5. After some preliminary testing, respondent accepted Mota's reported taxable sales.

[4] Mr. Adolfo Alvarez Mota initially opened Mota's in 2002 as a sole proprietorship. Respondent closed out the sole proprietorship's seller permit and opened a new permit in appellant's name after Mr. Mota incorporated his business.

[5] The audit work papers indicate respondent allocated reported taxable sales based on an apportionment of reported local taxes.

Consequently, the audit focused exclusively on Magpie's sales.

6. Preliminary markup calculation based on appellant's FITRs indicated markups of 103.09 percent for 2011, 153.20 percent for 2012, 117.04 percent for 2013, and 124.50 percent for the three years combined. Respondent considered the markups low for appellant's restaurants and unusually inconsistent, and it concluded that further examination was warranted.
7. Respondent examined Magpie Grill's POS data and found that appellant recorded sales tax reimbursement of $244,082 collected during the liability period. Respondent divided the recorded sales tax reimbursement by the sales tax rate for each quarter to calculate audited taxable sales of $2,732,373.
8. Respondent deducted Magpie's reported taxable sales of $1,149,500 from audited taxable sales of $2,732,373 to calculate unreported taxable sales of $1,582,874 (rounded) for the liability period. The tax due on the measure of $1,582,874.00 was $141,511.46.
9. Based on the foregoing, respondent issued the April 9, 2015 NOD to appellant.
10. Appellant filed a timely request for redetermination with respondent.
11. Respondent issued the Decision denying appellant's petition for redetermination.
12. This timely appeal followed.

DISCUSSION

Issue 1: Is appellant entitled to a reduction to the measure of unreported taxable sales?

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 the sales tax, sales of hot food to-go and sales of all (hot and cold) food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (2) & (7).)

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 books of account and other

records necessary to determine the correct tax liability. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Other records should include bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (Cal. Code Regs., tit. 18, § 1698(b)(1)(B).)

When a taxpayer appeals a determination, respondent has a minimal, initial burden of showing that its determination was rational and reasonable. (*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, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.)

Here, respondent used a direct audit approach by utilizing appellant's own POS data to determine taxable sales on an actual basis. As indicated in the Factual Findings, appellant recorded its collection of $244,082 in sales tax reimbursement from Magpie's customers during the liability period, and that amount of tax translates to taxable sales of $2,732,373. Magpie reported taxable sales during the liability period totaling $1,149,500. Respondent simply deducted those reported taxable sales from audited total taxable sales to calculate the taxable measure at issue here. Respondent's decision to use this direct audit approach, based on appellant's own records, was a rational one, and it was reasonably calculated to determine the correct tax liability. Furthermore, the audit work papers show that respondent correctly analyzed the data and calculated the liability. The evidence establishes a reasonable and rational basis for respondent's determination. Consequently, the burden of proof shifts to appellant to provide evidence to prove a more accurate measure of taxable sales.

Appellant argues that the determination is based on circumstantial evidence and faulty reasoning. It contends that respondent did not follow standard audit procedures because it failed

to test the reliability of the POS data in violation of its own Audit Manual.[6] Appellant claims that respondent did not perform a shelf test,[7] but did an observation test to determine a credit card ratio[8] of 52 percent.[9] Appellant argues that respondent should be compelled to use this credit card ratio, which will result in an understatement of $897,325.[10] Appellant also asserts that respondent's reliance on POS data was unreasonable because the entries were not made by the taxpayer;[11] they were made by servers and cashiers who made errors. In addition, appellant argues that the POS system data is not reliable because it did not reflect discounts, complimentary food and beverages (comps), or gift certificates, some of which appellant donated to local schools.[12] Appellant contends that its POS system did not allow the entry of corrections or voids and that discounts, comps, and gift certificates were entered as full-priced sales. Lastly, appellant also argues that the determined markup of 352 percent is unheard of in the industry and is evidence that the POS data is inaccurate. Each of these arguments will be addressed below.

In the end, appellant concedes a lesser liability measured by unreported taxable sales of

[6] Respondent's Audit Manual, which generally describes respondent's audit policies and procedures, does not constitute legal authority. Nevertheless, it can be a useful resource to which the Office of Tax Appeals may look for assistance interpreting, or determining the weight to be given to, audit findings. (See *Yamaha Corp. of Am. v. State Bd. of Equalization* (1998) 19 Cal. 4th 1, 25; *Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

[7] A shelf test is an accounting comparison of known costs and associated selling prices, which is used to compute markups.

[8] A credit card analysis typically determines the ratio of purchases made using some form of bank card to total purchases and uses that credit card ratio and third-party data concerning total electronic payments credited to appellant's bank account to estimate sales. (See, for example, the discussion regarding IRS Form 1099-K data, below.)

[9] There was no observation test done at Magpie. The observation test was done at Mota's. This opinion will not further discuss this assertion.

[10] During respondent's internal appeal process, appellant argued that Magpie's credit card ratio was 80-85 percent. However, appellant makes no such argument, and has offered no evidence in support of such argument, here.

[11] Appellant asserts that neither the "taxpayer" nor the "owner" record sales in the POS system. Since appellant, a corporation, can only act through its employees, including servers and cashiers, we infer that appellant is actually referring to Mr. Mota.

[12] Appellant states that it gave happy hour discounts, kids ate free on Tuesdays (when an accompanying adult paid full price), and dissatisfied customers would not have to pay for their meals. It also asserts that the gift cards donated to local schools are for $500 to $1,000.

$817,344.73 (as opposed to the $1,582,874.00 measure determined by respondent[13] and the $897,325.00 measure referred to above) which appellant calculated by reducing reported cost of goods sold (COGS) shown on appellant's FITRs for 2011, 2012, and 2013 by 3 percent for spoilage and 3 percent for self-consumption and then applying what appellant considers an acceptable markup of 275 percent.[14]

The evidence does not support appellant's argument that the determination is based on faulty reasoning. As stated above, respondent established a reasonable and rational basis for its determination. Furthermore, the POS data that shows appellant collected sales tax reimbursement from its Magpie customers totaling $244,082 during the liability period is direct evidence of that fact and not circumstantial evidence, which typically requires inference to prove the fact at issue. (*Caliber Paving Co. v. Rexford Industrial Realty & Management* (2020) 54 Cal.App.5th 175, 191 [citing 1 Witkin, Cal. Evid. (5th ed. 2012) Circumstantial Evidence, § 1, pp. 358-359].) No inference is necessary. Regardless of the type of evidence, what matters is the persuasive power of the evidence. Here, the evidence that appellant recorded collection of the sales tax reimbursement is persuasive evidence that appellant collected it.

Regarding appellant's argument that respondent should have conducted additional tests to confirm the results of its credit card analysis, the evidence shows that the Magpie's liability was not based on a credit card analysis. As already stated, respondent based that determination on facts stated in appellant's records, which show that appellant collected the sales tax reimbursement from Magpie's customers. If the facts recorded by appellant are inaccurate, appellant has the burden of proving the inaccuracies by impeaching its own records. Furthermore, appellant's argument that the observation test resulted in a 52 percent credit card ratio which should result in an understatement of taxable sales of $897,325 misstates the facts. The approximately 52 percent credit card ratio was computed in connection with the preliminary analysis of Mota's sales, not Magpie's; and if a 52 percent credit card ratio was applied, the

[13] In one of its briefs, appellant incorrectly refers to $1,559,976 as the audited measure of unreported taxable sales, but the correct figure for unreported taxable sales is $1,582,874 (rounded). Appellant also contended at some point that respondent should not have assessed a negligence penalty as this was appellant's first audit. However, respondent did not assess a negligence penalty in this audit, thus we need not discuss the issue further.

[14] "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).

measure of unreported sales would not be $897,325. POS data shows credit card sales of $1,853,378, cash sales of $1,108,617, total sales of $2,961,995, and a credit card ratio of 62.57 percent.[15] IRS Forms 1099-K (1099s) confirm $1,095,549 in credit card payments (less tip but including tax) deposited to appellant's bank account in 2011 and 2012.[16] Comparable POS data for the same period indicates credit card sales of $1,071,260, which is $24,290 less than indicated on the 1099s. If the 52 percent credit card ratio were applied to the amounts shown by the POS data, the resulting total sales would be $3,564,188, and the unreported taxable sales would total $2,414,688.

Appellant seeks to impeach its own records by pointing out that the entries were made by employees, not by Mr. Mota, and claiming that the records contain errors, some simply mistakes that the POS system would not allow appellant to correct and others that were unavoidably misleading because the POS system would not allow voids, comps, discounts, or gift certificates to be entered correctly. The POS data in question is part of appellant's business records, regardless of whether Mr. Mota or one of appellant's employees made the entries. Furthermore, the evidence does not show that the transaction-level POS data was wrong. According to the audit work papers, Magpie used a "Restaurant Pro" POS system, which indicates the system was designed specifically for use in a restaurant. It seems unlikely that a POS system designed for use in a restaurant would be unable to accurately handle all of the functions discussed above. Mr. Mota was apparently able to identify errors and delete the offending data from the monthly summaries, which were used later to prepare the sales and use tax returns. However, appellant has not provided the evidence upon which Mr. Mota relied when deleting sales. Nor has it proved a single instance of these claimed inaccuracies or offered any credible explanation for its consistent failure to report a substantial percentage of its taxable sales.

Appellant's calculation of an achieved markup of 352 percent, which it asserts is unheard of in the restaurant business, is unpersuasive. The calculation uses amounts for COGS that are taken from appellant's FITRs. The evidence proves that reported amounts are unreliable, and appellant has not provided source documents (e.g., purchase invoices) to verify the accuracy of

[15] The dollar amounts are excluding tips but including sales tax reimbursement.

[16] Form 1099-K 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.

its claimed COGS. Also, the evidence does not prove that a 352 percent markup is unreasonable. Finally, appellant's calculation of an understatement totaling $817,345 (rounded) is also based on the same, unreliable COGS, and uses a 275 percent markup that has no factual basis in our record.

To summarize, appellant's POS data shows that appellant collected sales tax reimbursement of $244,082. That translates to taxable sales of $2,732,373 for the liability period. Deducting Magpie's reported sales of $1,149,500 leaves unreported taxable sales of $1,582,873. The POS data is the original source data for recorded sales and is thus direct and persuasive evidence of taxable sales. It was appellant's burden to prove a more accurate measure. Appellant has not successfully impeached the POS data upon which the determination is based, and it has not proved a more accurate measure. Therefore, appellant is not entitled to a reduction to the measure of unreported taxable sales.

Issue 2: Is appellant entitled to have all or any part of the failure-to-remit penalty abated or relieved?

R&TC section 6597(a)(1) provides, in pertinent part, that any person who knowingly collects sales tax reimbursement and who fails to timely remit it to the state shall be liable for a penalty of 40 percent of the amount not timely remitted. The penalty does not apply if the person's liability for unremitted sale tax reimbursement averages $1,000 or less per month or does not exceed 5 percent of the total amount of the tax liability for which the sales tax reimbursement was collected for the period in which the tax was due, whichever is greater. (R&TC, § 6597(a)(2)(A).) The law provides for relief of the penalty if the evidence shows that the failure to remit the taxes was due to reasonable cause or to circumstances beyond the taxpayer's control and occurred notwithstanding taxpayer's exercise of ordinary care and the absence of willful neglect. (R&TC, § 6597(a)(2)(B).)

R&TC section 6597 does not require proof of fraud or intent to evade tax. Insofar as the taxpayer's intent is concerned, the statute requires only proof that the taxpayer knowingly collected and failed to remit the tax. Consequently, respondent need only produce evidence to show, by a preponderance of the evidence, that it correctly imposed the penalty. (*Appeal of Finnish Line Motorsports, Inc.*, 2019-OTA-138P.) Proof by clear and convincing evidence is not required. (*Ibid*.)

Appellant argues that the penalty cannot be sustained unless respondent proves "without

a doubt the taxpayer's intent." It contends that the POS data alone does not prove that appellant collected sales tax reimbursement and that respondent must trace the data to cash register tapes, invoices, or account journals to verify such collection. Appellant asserts the penalty should not be imposed because this is appellant's first audit, and appellant reiterates its argument that the underlying liability is grossly overstated, claiming that the POS data contains inherent errors and is unreliable. Appellant has not argued that its failure to remit the tax was due to reasonable cause or to circumstances beyond the taxpayer's control and occurred notwithstanding taxpayer's exercise of ordinary care and the absence of willful neglect.

Respondent carried its burden of proving that it correctly imposed the 40 percent penalty for appellant's collection of sales tax reimbursement of $141,511.46 and its failure to remit that amount to respondent. As explained above, the law does not require proof of fraudulent intent. It requires only proof that the taxpayer knowingly collected and failed to remit the tax and that the unremitted tax exceeds the highest of the alternative thresholds set forth in R&TC section 6597(a)(2)(A). The first threshold is an average of $1,000 per month and the second alternative threshold (5 percent of the total amount of the tax liability for the quarter for which the sales tax reimbursement was collected) was not greater than $1,054 for any quarter at issue, while unremitted tax in this case was between $9,033 and $13,386 per quarter, or between $3,175 and $4,584 per month.[17] Therefore, respondent caried its burden by producing evidence to prove that for all 36 months of the liability period, appellant consistently failed to remit tax collected on more than half of its sales to Magpie customers, and that the unremitted tax far exceeds the statutory thresholds.

The Opinion has already addressed, above, appellant's arguments contesting the determined unreported taxable sales. The POS data alone gives rise to a presumption that respondent correctly determined the taxes due. Respondent was not required to trace the data to cash register tapes, invoices, or account journals to verify such collection. It is appellant's burden to rebut the presumption.

Finally, R&TC section 6597(a)(1) states that any person who knowingly collects sales tax reimbursement and fails to remit the tax to respondent "shall be liable" for the failure-to-remit

[17] Although not material to the findings herein, respondent's audit schedule 12A-1 reflects a misinterpretation of R&TC section 6597(a)(2)(A) in that it appears to calculate the second alternative threshold as 5 percent of appellant's reported sales tax.

penalty. There is no provision in the Sales and Use Tax Law that provides for an exception in the case of a first audit.

The evidence establishes that appellant knowingly collected $141,511.46 in sales tax reimbursement from its customers and failed to remit that amount to respondent, and that respondent correctly calculated and imposed the failure-to-remit penalty. Appellant has failed to prove otherwise. It has also failed to argue or prove that its failure to remit the collected tax reimbursement to respondent was due to reasonable cause or to circumstances beyond the appellant's control and occurred notwithstanding its exercise of ordinary care and the absence of willful neglect. Therefore, appellant is not entitled to have all or any part of the failure-to-remit penalty abated or relieved.

HOLDINGS

1. A reduction to the measure of unreported taxable sales is not warranted.
2. No part of the failure-to-remit penalty should be abated or relieved.

DISPOSITION

Respondent's action denying appellant's petition for redetermination is sustained.

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Michael F. Geary
Administrative Law Judge

We concur:

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Teresa A. Stanley
Administrative Law Judge

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Josh Aldrich
Administrative Law Judge

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