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2023 – OTA – 221
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:

D. LUEVANO
dba, Bar Rio
dba, La Movida Dance Club

OTA Case Nos. 18063267, 18063268
CDTFA Case IDs: 785465, 792703

OPINION

Representing the Parties:

For Appellant: D. Luevano

For Respondent: Randy Suazo, Hearing Representative
Christopher Brooks, Tax Counsel IV
Jason Parker, Chief of Headquarters Ops.

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

N. RALSTON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, D. Luevano (appellant) appeals a 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 September 30, 2013 (Case No. 18063267) and a separate NOD issued on January 13, 2014 (Case No. 18063268). The NOD issued on September 30, 2013, is for a tax liability of $81,611.35, applicable interest for the period January 1, 2010, through December 31, 2012 (audit period) and a negligence penalty of $8,161.16. Respondent's decision reduced the understated measure of tax from $997,011.00 to $515,268.00 and denied the remainder of the petitioned amount (the appeal of Bar Rio). The NOD issued on January 13, 2014, is for a tax liability of $7,616.13, applicable interest for the same audit period and a negligence penalty of $761.63. Respondent's decision deleted the negligence penalty and reduced the understated measure of tax from $97,881.00 to $71,636.00,

[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.

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and denied the remainder of the petitioned amount (the appeal of La Movida Dance Club).

Office of Tax Appeals (OTA) Administrative Law Judges: Teresa A. Stanley, Andrew J. Kwee, and Natasha Ralston, held an oral hearing for this matter in Sacramento, California, on December 13, 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 further reductions to the measure of tax are warranted.
2. Whether Bar Rio was negligent.

FACTUAL FINDINGS

Bar Rio

1. During the audit period, appellant operated a bar in Salinas known as the Bar Rio. In addition to selling beer, liquor, and wine, the business also derived income from a juke box and pool tables.
2. Respondent audited appellant for the audit period. Upon audit, appellant provided copies of federal income tax returns (FITRs) for 2010, and 2011, and also provided various purchase invoices. Appellant also provided a price list and prepared a Bar Fact Sheet.[2] However, appellant did not provide cash register tapes, a sales journal, or a purchase journal for audit. Due to the lack of books and records, respondent used the markup method to compute appellant's audited taxable sales.[3] In the audit, respondent computed unreported taxable sales of $997,011. Also, respondent imposed a negligence penalty.
3. On September 30, 2013, respondent issued an NOD to appellant for the liability disclosed by audit.
4. On October 16, 2013, appellant filed a timely petition for redetermination of the NOD.

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[2] A Bar Fact Sheet is a form that respondent's auditor gives to a taxpayer so that the taxpayer can list information regarding selling prices, happy hours, self-consumption, and other information pertinent to the audit.

[3] "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 ÷ .70 = 0.42857). 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 (0.30 ÷ 1.00 = 0.30).

5. Respondent subsequently prepared two reaudits based on new information. In the second reaudit respondent performed a shelf test, which is an accounting comparison of known costs and associated selling prices used to compute markups. The selling prices for individual liquor drinks as listed on a Bar Fact Sheet were used to calculate sales proceeds from a bottle,[4] and bottle sales were compared to bottle costs from purchase invoices from the second quarter of 2012 to compute markups for well liquor and call liquor. Respondent compared costs from available purchase invoices for the third and fourth quarters of 2012 to selling prices stated on a Bar Fact Sheet, to compute the markups for bottled domestic beer and bottled import beer (appellant did not sell draft beer).
6. Respondent compared costs from available purchase invoices to the selling price of $3.00 for non-alcoholic beverages, observed at the time of the audit, to compute a markup of 12,357 percent for non-alcoholic beverages. However, the markup for non-alcoholic beverages was not used in the calculation of the weighted markup.
7. Although appellant sold wine, respondent could not find any wine purchases in the available purchase invoices, and thus, did not compute a markup for wine. The above markups for beer and liquor were weighted based on the ratio of purchases in each drink category as determined in a segregation of merchandise purchases for 2012, to compute a weighted markup of 355.08 percent.
8. Starting in May 2012, appellant increased her selling prices for beer by $1.00. Thus, respondent reduced the beer selling prices listed on the Bar Fact Sheet by $1.00 for periods prior to May 1, 2012, then recalculated a weighted markup of 256.23 percent, using the same method as described above.[5] Respondent used the markup of 256.23 percent for periods prior to May 1, 2012.
9. Respondent used the available purchase invoices and information from appellant's vendors to compile purchases of alcoholic beverages and non-alcoholic beverages for 2010, 2011, and 2012.

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[4] This calculation takes into consideration pour size, over pouring, spillage, waste and breakage.

[5] Beer accounted for 87.78 percent of appellant's merchandise purchases in 2012, and thus, the beer markups were given much more weight than the liquor markups, which accounts for the dramatic reduction in the overall weighted markup.

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10. In 2012, Bar Rio purchased alcoholic beverages for both Bar Rio and La Movida Dance Club (La Movida), which is a separate business owned by appellant (discussed below).[6] Respondent reduced the alcohol purchases made by Bar Rio in 2012 by 20 percent to compute the alcohol purchases sold by Bar Rio in 2012. In total, respondent computed audited merchandise purchases (alcoholic and non-alcoholic beverages, combined) of $287,621 for the audit period. Respondent reduced audited merchandise purchases by $27,812 made in 2010 for a documented inventory loss due to a fire at appellant's business, and then reduced merchandise purchases for the audit period by $1,800 for self-consumption, and an additional two percent for pilferage, to compute audited cost of goods sold of $252,849 for the audit period.
11. This amount was segregated into $202,284 for the period January 1, 2010, through April 30, 2010, and $50,565 for the period May 1, 2012, through December 31, 2012. Respondent added the audited markup of 256.23 percent to audited cost of goods sold of $202,284 for the period January 1, 2010, through April 30, 2012, and added the audited markup of 355.08 percent to audited cost of goods sold of $50,565 for the period May 1, 2012, through December 31, 2012, to compute audited taxable sales, including sales tax reimbursement, of $950,699 for the audit period. Sales tax reimbursement was removed from this amount to compute audited taxable sales of $867,513, which was compared to reported taxable sales of $352,246 to compute unreported taxable sales of $515,267 (as compared to unreported taxable sales of $997,011 computed in the original audit).
12. Respondent issued its Decision on April 27, 2018, recommending that the determined measure of tax be reduced from $997,011 to $515,268, as computed in the second reaudit, that the petition for redetermination be otherwise denied, and upholding the negligence penalty.

[6] OTA is issuing a consolidated Opinion addressing both businesses.

La Movida

13. Appellant operated a night club in Salinas known as La Movida Dance Club (La Movida). At this business, appellant sold beer, wine, liquor, hot prepared food, and non-alcoholic beverages. The night club provided live entertainment and DJs on the weekend with a cover charge of $10 per person (the cover charge was for entertainment only).
14. Appellant obtained the liquor license for this business on January 11, 2012, and prior to that date, appellant only sold non-alcoholic beverages.
15. Respondent audited appellant for the audit period. Upon audit, appellant provided copies of FITRs for 2010, and 2011, and also provided various purchase invoices. Appellant also provided a price list and prepared a Bar Fact Sheet. However, appellant did not provide cash register tapes, a sales journal, or a purchase journal for audit. Due to the lack of books and records, respondent used the markup method to compute appellant's sales. The audit resulted in unreported taxable sales of $97,881.
16. On January 13, 2014, respondent issued an NOD to appellant for the liability disclosed by audit.
17. Appellant filed a timely petition for redetermination of the NOD on January 29, 2014.
18. Respondent subsequently prepared two reaudits based on new information. In the second reaudit, respondent performed a shelf test for non-alcoholic beverages, comparing costs from available purchase invoices from August, September, and October 2012, to selling prices of $3.00 that respondent observed on March 27, 2013, which resulted in a 793.71 percent markup for non-alcoholic beverages. However, the markup for non-alcoholic beverages was not used in the calculation of the weighted markup.
19. Respondent performed a shelf test on bottled beer, comparing costs from available purchase invoices for the third quarter 2012 and the fourth quarter 2012, to selling prices stated in a Bar Fact Sheet, computing separate markups for domestic beer and imported beer.[7] The selling prices for individual liquor drinks as listed on a Bar Fact Sheet were used to calculate sales proceeds from a bottle,[8] and bottle sales were compared to bottle

[7] This calculation takes into account breakage of bottled beer. Appellant did not sell draft beer.

[8] This calculation takes into consideration pour size, over pouring, spillage, waste, and breakage.

costs from purchase invoices from the second quarter of 2012 to compute markups for well liquor and call liquor.

20. Although appellant sold wine, respondent could not find any wine purchases in the available purchase invoices, and thus, did not compute a markup for wine. The above markups for beer and liquor were weighted based on the ratio of purchases in each drink category as determined in a segregation of merchandise purchases for 2012, to compute a weighted markup of 351.89 percent.

21. Appellant stated that starting in May 2012, she increased her selling prices for beer by $1. Thus, respondent reduced the beer selling prices listed on the Bar Fact Sheet by $1 for periods prior to May 1, 2012, then recalculated a weighted markup of 263.57 percent, using the same method as described above.[9] Respondent considered the markup of 263.57 percent to be the markup for periods prior to May 1, 2012.

22. Respondent scheduled non-alcoholic beverage purchases from purchase invoices for August, September, and October 2012 of $395, then multiplied that amount by four to compute audited annual non-alcoholic beverage purchases of $1,580. Since appellant did not purchase alcohol prior to 2012, total merchandise purchases for 2010 and 2011 were $1,580 for each year.

23. Appellant did not provide purchase invoices for alcohol. Respondent obtained merchandise purchase information from the audit of Bar Rio and allocated 20 percent of Bar Rio's alcohol purchases for 2012 to La Movida, which totaled $25,020 for that year. The alcohol purchases of $25,020 were added to non-alcoholic beverage purchases of $395 to compute total merchandise purchases of $25,416 for 2012.[10]

24. Respondent computed total merchandise purchases of $28,576 for the audit period. Respondent reduced audited merchandise purchases by two percent for pilferage, to compute audited cost of goods sold of $28,004.[11] This amount was segregated into

[9] Beer accounted for 84.39 percent of appellant's merchandise purchases in 2012, and thus, the beer markups were given much more weight than the liquor markups, which accounts for the dramatic reduction in the overall weighted markup.

[10] $395 represents only 3 months of non-alcoholic beverage purchases. One full year of non-alcoholic beverage purchases was $1,580. Respondent erred in not using a full year of non-alcoholic beverage purchases in this calculation. This error benefits appellant.

[11] No adjustment for self-consumption was made in this audit because appellant stated that all of the self-consumption was done through the related business, Bar Rio.

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$11,400 for the period January 1, 2010, through April 30, 2012, and $16,604 for the period May 1, 2012, through December 31, 2012.

25. Respondent added the audited markup of 263.57 percent to audited cost of goods sold of $11,400 for the period January 1, 2010, through April 30, 2012,[12] and added the audited markup of 351.89 percent to audited cost of goods sold of $16,604 for the period May 1, 2012, through December 31, 2012, to compute audited taxable sales, including sales tax reimbursement, of $116,479 for the audit period.[13] Sales tax reimbursement was removed from this amount to compute audited taxable sales of $108,029, which was compared to reported taxable sales of $36,586 to compute unreported taxable sales of $71,443. Respondent noted that reported taxable sales exceeded audited taxable sales by $192 in 2010. Thus, respondent accepted reported taxable sales in 2010 as accurate, and eliminated the $192 credit measure in 2010, which resulted in unreported taxable sales of $71,636. In the second reaudit, respondent recommended deleting the negligence penalty.

26. Respondent issued its Decision on April 27, 2018, recommending that the determined measure of tax be reduced from $97,811 to $71,636, as computed in the second reaudit, the negligence penalty be deleted, and that the petition for redetermination be otherwise denied.

27. Appellant filed the instant appeal with the OTA.

DISCUSSION

Issue 1: Whether appellant has shown that the measure of tax established in the second reaudit is excessive.

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 establish otherwise. (R&TC, § 6091.)

[12] Respondent acknowledges that appellant did not sell alcohol prior to January 1, 2012. However, respondent used the markup for alcohol for periods prior to January 1, 2012. The audited markup for non-alcoholic beverages of 793.71 percent is much greater than the alcohol markup of 263.57 percent. Thus, appellant benefited from the use of the lower alcohol markup for periods prior to January 1, 2012.

[13] Appellant sold hot food, which is subject to tax, but respondent did not include hot food sales in its calculation of audited taxable sales, which benefits appellant.

When 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.) In the case of an appeal, 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 its initial 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. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.) To satisfy the burden of proof, a taxpayer must prove: (1) that the tax assessment is incorrect, and (2) the proper amount of the tax. (*Appeal of AMG Care Collective*, supra.)

In the cases at hand, appellant did not provide cash register tapes, sales journals, or purchase journals for audit. Due to the lack of books and records, it was reasonable for respondent to use an indirect method (the markup method) to compute appellant's sales. (*Appeal of Amaya*, 2021-OTA-328P.) Respondent used factual information regarding appellant's selling prices and costs to establish the markups, and also used factual information regarding appellant's merchandise purchases. Thus, respondent has met its initial burden of showing that its determination was both rational and reasonable. Therefore, the burden of proof shifts to appellant to provide evidence to support adjustments to the audit.

Bar Rio

With regard to Bar Rio, appellant contends that the selling prices used in the shelf test for non-alcoholic beverages are overstated, resulting in an overstated markup for non-alcoholic beverages. In this audit, the method of computing the weighted markup was to multiply the audited markup for each product category by a weighting factor for that product category to compute a weighted markup for each product category, then add the weighted markups for each product category together to compute the weighted markup for all products combined. As explained above, the markup for non-alcoholic beverages was not used to calculate the weighted markup. In other words, the weighted markup for non-alcoholic beverages was zero. Using any markup for non-alcoholic beverages would increase the total weighted markup for all product

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categories because the weighted markup for non-alcoholic beverages would be greater than zero and would be added to the other weighted markups to compute the total weighted markup for all product categories. Thus, appellant does not benefit from reducing the markup for non-alcoholic beverages and then including that reduced markup in the audit calculations. Therefore, no adjustment is warranted for appellant's argument regarding lower selling prices for non-alcoholic beverages.

Appellant contends that some of the purchase invoices used in respondent's computation of merchandise purchases were duplicated (appellant provided copies of three purchase invoices at respondent's appeals conference in support of this argument). Respondent acknowledges that some purchase invoices have been duplicated in the audit. However, respondent also noted some computational errors in the audit. Making corrections for the duplicated purchases and the computational errors results in increasing the amount of unreported taxable sales from $515,268 to $618,258. At the hearing, appellant provided a spreadsheet listing the specific purchase invoices from respondent's exhibits that appellant claimed showed that respondent had duplicated several transactions in its audit calculations. This matter contained the original audit and two reaudits. Respondent included audit schedules from all three audits in its exhibits, thus the same worksheet or schedule was included multiple times in respondent's exhibits and do not actually represent duplicate purchase invoices. Based on the foregoing, no adjustment for the duplicated purchases are warranted.

Appellant contends that a larger adjustment for the fire loss should be made. As stated above, respondent reduced merchandise purchases in 2010 by $27,812 to account for the fire loss. Appellant asserts, and respondent does not dispute, that a fire occurred on November 8, 2009 (which is prior to the audit period). Appellant also asserts that she did not re-open Bar Rio until June 2010. Appellant wants a larger adjustment to account for the fact that she could not re-open the business until June 2010. An adjustment to the audit should not be made to account for loss of income due to appellant's business being closed until June 2010. With her brief, appellant provided a copy of a Statement of Loss from her insurance company, which shows a loss for alcohol inventory of $27,812. Appellant has not provided documentation to support a larger loss of inventory.

Appellant contends that the audited cost of goods sold should be reduced by $25,014 for ending inventory that was not sold. With her brief, appellant provided copies of self-prepared

inventory sheets. The cost of goods sold equals beginning inventory plus merchandise purchases less ending inventory. This is because the beginning inventory was sold during the audit period while the ending inventory was not. Thus, in a markup audit, no adjustment is warranted for ending inventory unless an adjustment is also made for beginning inventory. According to appellant's FITR's, beginning inventory on January 1, 2010, was $5,000. Appellant did not provide a FITR for 2012. Instead, appellant provides the aforementioned self-prepared inventory sheet listing ending inventory on December 31, 2012, of $25,014. However, at the hearing, appellant stated that much of her inventory was destroyed during the fire, and that she was required to destroy any inventory that had not been damaged in the fire in order to avoid any contamination.

There is no dispute that appellant had a major fire on November 8, 2009, which was less than two months prior to the start of the audit period. Thus, appellant's beginning inventory on January 1, 2010, would likely be far lower than normal, and appellant would likely gradually build up her inventory to normal levels after January 1, 2010. There is no dispute that on November 8, 2009, $27,812 of merchandise was destroyed in a fire. Thus, on that date, appellant had on hand inventory in the amount of $27,812. Therefore, the $25,014 inventory amount that appellant claims to have had on hand on December 31, 2012, would be reasonable. Subtracting beginning inventory of $5,000 from the $25,014 ending inventory results in an adjustment of $20,014 for the change in inventory. However, as stated above, appellant has already received an adjustment of $27,812 for the fire loss.[14] The adjustment for ending inventory has already been accounted for in the $27,812 fire loss. Thus, no further adjustment for ending inventory is warranted.

Appellant argues that the audit incorrectly includes California Redemption Value (CRV) in the purchase costs that were marked-up by respondent. With her brief, appellant provides copies of a report from one of her vendors, Couch Distributing, which shows purchases made by appellant from that vendor for 2010, 2011, and 2012. The report shows separate amounts for the purchase price and CRV. OTA's review of the audit workpapers shows that in computing the markups, respondent included CRV in the cost amounts, which resulted in a lower markup than

[14] A fire occurring prior to the audit period would have no impact on the merchandise purchased during the audit period. The inventory that was lost in the fire was inventory that was purchased in 2009, not 2010. The merchandise that was purchased in 2010 was not destroyed in the fire but was eventually sold by appellant. This error benefits appellant.

would have been computed without including CRV in the cost. The audited markups were added to cost amounts that included CRV. Respondent's method of including CRV in both the costs that were used to compute the markups and the costs that the markups were applied to is the proper method because CRV was part of appellant's cost of goods sold. Further, if CRV were removed from appellant's purchases it would be to appellant' detriment because it would have increased the audited markup percentage which would have increased the audited taxable sales.

Appellant asserts that audit schedule 12A-6 from respondent's audit work papers states that Bar Rio transferred 80 percent of the merchandise it purchased to La Movida. Appellant states that is incorrect. However, audit schedule 12A-6 shows that 20 percent (not 80 percent) of the merchandise purchased by Bar Rio was transferred to La Movida. Thus, appellant is mistaken regarding the statements made on audit schedule 12A-6.

Appellant asserts that in an undercover observation, respondent's employee stated that she was charged $5.00 for a beer and $3.00 for a soda. Appellant disputes that these were her selling prices. In the second reaudit, the beer shelf tests use a selling price of $3.00 for all beers, and the soda shelf test was not used in the second reaudit calculations. Thus, the prices observed in the undercover observation were not used in the second reaudit calculations, making this argument irrelevant.

Appellant has failed to provide any documentation or other evidence from which a more accurate determination can be made, thus, appellant has failed to meet her burden of establishing that a further reduction to the measure of unreported taxable sales is warranted.

<u>*La Movida*</u>

Appellant argues that this business did not start selling alcohol until July 22, 2012, and the audit calculations should be adjusted to remove alcohol sales for periods prior to July 22, 2012. Appellant asserts that the requirements of her liquor license required her to sell food, and appellant further asserts that she did not start selling food until July 22, 2012, and thus, she also did not start selling alcohol until that date. To support the argument that this business did not start selling alcohol until July 22, 2012, appellant provided copies of: 1) a Petition for Conditional License dated November 15, 2011 (which is appellant's application for a liquor license); 2) an invoice from the Monterey County Health Department Environmental Health Division, dated July 20, 2012, for health permit fees; 3) an Environmental Health Division Food

Inspection Report,; 4) cash register tapes dated July 22, 2012, which appellant asserts represent the first day alcohol was sold; and 5) cash register tapes dated July 24, 2012.

Respondent alleges that, at the time of the audit, appellant told respondent that 20 percent of the alcohol purchased in 2012 by related business Bar Rio was transferred to La Movida, and thus, respondent allocated 20 percent of the alcohol purchased in 2012 by Bar Rio to La Movida. In that manner, respondent established alcohol purchases transferred to La Movida in 2012 of $25,020.

Appellant now denies that she told respondent that 20 percent of the alcohol purchased from Bar Rio in 2012 was transferred to La Movida, and appellant argues that the audited alcohol purchases for La Movida are excessive. Appellant acknowledges that alcohol was transferred from Bar Rio to La Movida. However, appellant did not maintain a record of such transfers. In the absence of transfer records from appellant OTA finds respondent's contemporaneous records, as reflected in the audit file, to be reliable. Respondent acted reasonably in allocating 20 percent of the Bar Rio alcohol purchases for 2012 to La Movida.

Moreover, reducing the amount of alcohol purchases for La Movida would increase the amount of alcohol purchases for Bar Rio by an equal amount. Appellant has not agreed to have the audit liability of Bar Rio increased to account for alcohol that was not transferred to La Movida. Also, appellant has not provided more accurate information regarding the amount of alcohol transferred to La Movida. Therefore, no adjustment should be made to the amount of alcohol purchases in the La Movida audit.

Also, appellant continues to argue that she sold water for $1.00 and soda for $1.50. Appellant states that the menu respondent relied upon for the $3.00 selling price of non-alcoholic beverages is not her menu, and she does not know where respondent got that menu. Appellant asserts that the initials "D.L." on that menu are not her initials. In support of her argument regarding the selling prices for water and soda, appellant provides the cash register tapes previously mentioned for July 22, 2012, and July 24, 2012, which she asserts show selling prices of $1.00 for water and $1.50 for soda. Respondent counters that the selling prices for water and soda used in the audit were based on undercover observations of the business at the time of the audit, which was supported by the menu that appellant denies was hers.

As stated above, respondent did not use the audited markup of 793.71 percent in the audit calculations, but instead used the lower alcohol markups of 263.57 percent for the period

January 1, 2010, through April 30, 2012, and 351.89 percent for the period May 1, 2012, through December 31, 2012. Appellant's argument regarding the selling prices of water and soda only benefit appellant if the resulting markup for non-alcoholic beverages is less than the 263.57 percent markup used for the period January 1, 2010, through April 30, 2012, and the 351.89 percent markup used for the period May 1, 2012, through December 31, 2012. Using appellant's selling prices of $1.00 for water and $1.50 for soda results in a markup for non-alcoholic beverages of 283.48 percent. The 283.48 percent markup is greater than the 263.57 percent markup used for the period January 1, 2010, through April 30, 2012, and thus, appellant's argument does not benefit her for that period. In this audit, the method of computing the weighted markup was to multiply the audited markup for each product category by a weighting factor for that product category to compute a weighted markup for each product category, then add the weighted markups for each product category together to compute the weighted markup for all products combined. As explained above, the markup for non-alcoholic beverages was not used to calculate the weighted markup. In other words, the weighted markup for non-alcoholic beverages was zero. Using any markup for non-alcoholic beverages would increase the total weighted markup for all product categories because the weighted markup for non-alcoholic beverages would be greater than zero and would be added to the other weighted markups to compute the total weighted markup for all product categories. Thus, for periods when appellant sold both alcohol and non-alcoholic beverages, appellant does not benefit from reducing the markup for non-alcoholic beverages and then including that reduced markup in the audit calculations.

The cash register tapes do not contain a register-generated description of the property being sold. Instead, appellant has made handwritten notes on the cash register tape copies. Thus, the cash register tapes are insufficient to show that appellant sold water for $1.00 and soda for $1.50. The selling prices observed by respondent in its undercover observation are the best evidence of appellant's selling prices. Thus, no adjustment for this argument is warranted.

Appellant contends that the allowance for bottle breakage should be increased from 1 percent to 2 percent. Respondent cites to its Audit Manual section 0806.60, which states that in an audit of a bar, a standard allowance of one percent for bottle breakage is allowed. Any adjustment greater than the one percent allowance must be documented by the taxpayer. (*Appeal of Amaya, supra.*) OTA finds that the policy stated in section 0806.60 of respondent's

Audit Manual of allowing a standard 1 percent allowance for bottle breakage and requiring the taxpayer to document a greater allowance is reasonable. (*Ibid.*) Thus, the burden of proof shifts to appellant to support a greater allowance for bottle breakage. Appellant has not provided documentation to support a 2 percent allowance for bottle breakage. Thus, no additional adjustment for bottle breakage is warranted.

Appellant contends that the liquor pour size should be increased from two ounces as used in the audit to three ounces. In her petition for redetermination filed with respondent, appellant indicates that her liquor pour size is in the range of 1.8 ounces to 2 ounces. Appellant's contention that the liquor pour size should be three ounces is in conflict with the statement she made in her petition letter that her liquor pour size is in the range of 1.8 ounces to 2 ounces. Also, appellant has not provided any documentation to support a liquor pour size of three ounces. Thus, we conclude that no adjustment to the two-ounce liquor pour size is warranted.

There is a dispute regarding when appellant started selling alcohol. Respondent believes that appellant started selling alcohol in January 2012, while appellant argues that she did not start selling alcohol until July 22, 2012. OTA finds appellant's arguments credible. Therefore, the markup for the period May 1, 2012, through July 21, 2012, should only reflect the markup for non-alcoholic beverages, which OTA calculates to be 283.48 percent using selling prices of $1.00 for water and $1.50 for soda. The audited markup for the period May 1, 2012, through July 21, 2012 (which is the markup for alcoholic beverages), is 351.89 percent, which is greater than the 283.48 percent markup. Thus, OTA finds that the audited markup for the 11-week period May 1, 2012, through July 21, 2012, should be reduced from 351.89 percent to 283.48 percent.

Appellant has failed to provide any documentation or other evidence from which a more accurate determination could be made, thus appellant has failed to meet her burden of establishing that any further reduction to the measure of unreported taxable sales is warranted.

<u>Issue 2: Whether Bar Rio was negligent.</u>

Respondent imposed the negligence penalty in the audit of Rio Bar due to the lack of books and records, and due to the size of the understatement in relation to the reported measure of tax. Appellant argues that she reported all of her taxable sales, and thus, there is no understatement of tax upon which to apply the penalty.

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

A taxpayer shall maintain and make available for examination on request by CDTFA 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: 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 keep complete and accurate records will be considered evidence of negligence and may result in penalties. (Cal. Code Regs., tit. 18, § 1698(k).)

California Code of Regulations, title 18, section (Regulation) 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.

Appellant only provided copies of FITRs and incomplete purchase invoices for audit. Appellant did not provide cash register tapes, sales journals, purchase journals, or a general ledger for audit. Thus, appellant did not maintain and make available for examination on request by CDTFA 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, as

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required by R&TC sections 7053 and 7054, and Regulation section 1698(b)(1). OTA thus finds that appellant was negligent in record keeping.

The understatement computed in the second reaudit of $515,268 represents an error ratio of 146.28 percent when compared to reported taxable sales of $352,246. Thus, appellant reported less than half of her taxable sales. The large error ratio is evidence of negligence in reporting.

Comparing audited taxable merchandise purchases of $287,621 to reported taxable sales of $352,246 results in a markup of only 22.5 percent. The audited markups were 355.08 percent for the period January 1, 2010, through April 30, 2012, and 256.23 percent for the period May 1, 2012, through December 31, 2012. Appellant has presented no arguments that would reduce the audited markups. Respondent asserts, and appellant does not dispute, that from July 22, 2005, through December 31, 2009, this business was owned by a limited liability company, and appellant was the sole member of that limited liability company. Thus, prior to the audit, appellant had extensive experience in operating this business. Appellant is knowledgeable about her business, and as such, appellant must have known that her markup was in excess of 200 percent. Appellant had to have known that reported taxable sales were substantially understated because reported taxable sales produced an unreasonably low markup of only 22.5 percent.

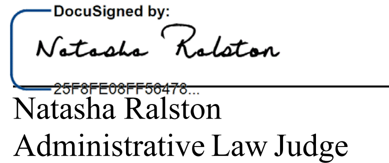
Persuasive evidence exists that appellant possessed experience and/or actual knowledge such that any bookkeeping and reporting errors cannot be attributed to appellant's bona fide and reasonable belief that her bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. Therefore, the negligence penalty was properly applied.

HOLDINGS

1. The audited markup for La Movida the 11-week period from May 1, 2012, through July 21, 2012, should be reduced from 351.89 percent to 283.48 percent. Appellant has failed to show that further reductions to the measure of tax are warranted.
2. Respondent has established that the negligence penalty is warranted as to Bar Rio.

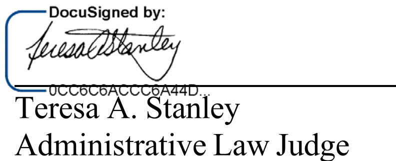
DISPOSITION

The audited markup for La Movida for the 11-week period May 1, 2012, through July 21, 2012, should be reduced from 351.89 percent to 283.48 percent. Respondent's action is otherwise sustained.

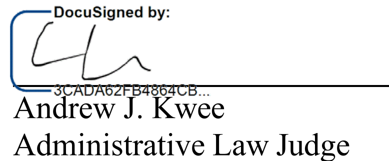


Natasha Ralston
Administrative Law Judge

We concur:



Teresa A. Stanley
Administrative Law Judge



Andrew J. Kwee
Administrative Law Judge

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