2023 – OTA – 292
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:

MINCAFE COFFEE CORPORATION,
dba Live Mixx Lounge

OTA Case No. 18053153
CDTFA Case ID 609861

OPINION

Representing the Parties:

For Appellant: Aksel Bagheri, Attorney

For Respondent: Randy Suazo, Hearing Representative
Chad Bacchus, Tax Counsel IV
Nalan Samarawickrema,
Hearing Representative

For Office of Tax Appeals: Deborah Cumins,
Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Mincafe Coffee Corporation (appellant) appeals a Decision and Supplemental Decision issued by the California Department of Tax and Fee Administration (respondent)[1] in response to appellant's timely petition for redetermination of an April 23, 2012 Notice of Determination (NOD).[2] The NOD was for tax of $224,927.87, plus applicable interest, and a 25-percent fraud penalty of $56,231.98 for the period April 1, 2007, through September 30, 2010 (liability period). In the Supplemental Decision, respondent reduced the tax liability from $224,927.87 to $138,478.17, adjusted the fraud penalty accordingly, and redetermined the remainder of the liability without further adjustment.

Office of Tax Appeals (OTA) Administrative Law Judges Richard Tay, Daniel K. Cho,

[1] Prior to July 1, 2017, sales and use taxes (and other business taxes and fees) were administered by respondent's predecessor, the 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, which established a deficiency measure of $2,597,131, consisting of unreported taxable sales of $2,590,785, and unreported self-consumption of taxable merchandise costing $6,346.

and Michael F. Geary held an oral hearing for this matter in Cerritos, California, on April 12, 2022. The hearing record remained open to allow the parties an opportunity to submit post-hearing briefs, and the record was closed on June 20, 2022.

ISSUES

1. Is appellant entitled to further adjustments to the audited measure of underreported taxable sales?
2. Has fraud been established by clear and convincing evidence?

FACTUAL FINDINGS

1. Appellant operated an eating, drinking, and entertainment establishment in downtown Pasadena from September 2001 through January 7, 2017.[3] The business was open from 9:00 p.m. to 2:00 a.m. on at least four evenings a week (Wednesday through Saturday) and was open five nights during some weeks.[4] According to appellant, the business was primarily a full-service restaurant and bar prior to January 1, 2009, when appellant closed the business for renovations, after which the business reopened in May 2009 as a nightclub.[5]
2. During the liability period, appellant reported total and taxable sales of $438,596, claiming no deductions.
3. Respondent audited appellant for the liability period. For audit, appellant provided a "Sales Log" for the third quarter of 2009 (3Q09) and 4Q09,[6] bank statements for the

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[3] Respondent refers to the business as a pub or lounge.

[4] Appellant's sales logs indicate the business was open on some Mondays and Tuesdays but closed on some Wednesdays, and there is anecdotal evidence in the Yelp reviews to the same effect.

[5] As will be explained more fully below, these two periods of operation, the first quarter of 2007 (1Q07) through 1Q09 and the period 2Q09 through 3Q10, will figure prominently in the audits.

[6] The sales log purports to list daily sales of liquor, beer, wine, nonalcoholic beverages, food, and "room rental" fees. The report for May 2009 shows sales on only five days: May 22 (Friday), 23 (Saturday), 26 (Tuesday), 29 (Friday), and 30 (Saturday). Appellant recorded alcoholic and nonalcoholic beverage sales in May of $9,394.90 and room rental fees (on May 20 only) of $1,000.00. For June, when the business was open on 16 nights, appellant recorded food and beverage sales of $19,650.65, and room rental fees (on 13 of the 16 days) of $13,500.00, for total sales of $33,150.65. For the following six months, recorded food and beverage sales show a precipitous drop, averaging just $8,455.36, while recorded room rental fees showed a comparable increase, averaging $20,183.00.

period June 1, 2009, through December 31, 2009,[7] merchandise purchase invoices for January and February 2011, a merchant account statement for the period January through May 2011, a Menu Item Food Cost Analysis Report (Cost Analysis Report) for the period March 1, 2011, through March 15, 2011, and a Sales (by category) Journal Report (Sales by Category Report) for the period May 1, 2011, through June 15, 2011. It also provided information regarding the bar's operations by completing a questionnaire known as a Bar Fact Sheet. Appellant stated it could not provide copies of its federal income tax returns for the liability period because it had not filed any. The business records appellant provided for the audit were inadequate for sales and use tax purposes.

4. Some of the business records provided by appellant indicated that a substantial portion of appellant's income consisted of room rental fees.[8] Appellant did not report these fees on its sales and use tax returns, and they are not included in the measure at issue in this appeal.
5. Respondent found that reported sales were well below what it expected for the business. That and the lack of records necessitated additional investigation and the use of an indirect audit method. Respondent initially decided to establish audited sales on a markup basis.
6. Respondent conducted the first audit and established a $2,597,131 deficiency measure consisting of unreported taxable sales of $2,590,785 and unreported self-consumed merchandise costing $6,346, subject to use tax.[9] Respondent also concluded that the understatement was the result of fraud or intent to evade the payment of tax.
7. On April 23, 2012, respondent issued the NOD, based on the above audit, for tax of $224,927.87, applicable interest, and a fraud penalty of $56,231.98.
8. On May 3, 2012, appellant filed a petition for redetermination, disputing the asserted

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[7] Appellant later provided additional bank statements, for several bank accounts, during the reaudit.

[8] For example, at some point in the audit process, appellant provided eight reports entitled "Liv Sales Log," and purporting to list daily sales by category (liquor, beer, wine, food, and room rental) for May through December 2009. The total recorded sales for those eight months were $79,732.77. Room rentals totaled $135,600.00. According to the evidence, appellant indicated that there were no private rooms at the business. Rather, appellant would section off part of the restaurant for the private party.

[9] Because two subsequent reaudits, discussed below, have resulted in adjustments to the liability, this Opinion will not discuss the details of the first audit.

liability on various bases.

9. After appellant filed its petition, respondent performed a first reaudit. To establish audited markups, respondent conducted shelf tests using the costs listed on purchase invoices appellant had provided, for the period January and February 2009, and selling prices listed on the bar menu or the Bar Fact Sheet.[10] Respondent computed markups as follows:

- for straight drinks (using a pour size of 1.75 ounces),[11] respondent calculated markups of 504.77 percent for sales at regular prices and 202.39 percent for sales at happy hour prices;[12]
- for cocktails (using a pour size of 2.43 ounces), respondent calculated markups of 1,179.26 percent at regular prices and 572.83 percent at happy hour prices;
- for bottled beer, respondent calculated markups of 339.28 percent at regular prices and 119.64 percent at happy hour prices;
- for draft beer (using a pour size of 14 ounces), respondent calculated markups of 298.25 percent at regular prices and 99.13 percent at happy hour prices; and
- for wine, respondent calculated markups of 137.97 percent at regular prices and 18.99 percent at happy hour prices.

10. Respondent used sales recorded on appellant's Sales by Category Report to compute the percentage of sales made at regular versus happy hour prices. It found that: 79.47 percent of appellant's liquor sales (both straight drinks and cocktails) were at regular prices, and 20.53 percent were at happy hour prices; 70.07 percent of its beer sales (both bottled and draft) were at regular prices, and 29.93 percent were at happy hour prices; and 88.89 percent of its wine sales were at regular prices, and 11.11 percent were at happy hour prices. Using those percentages and the audited markups noted above,

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[10] Respondent allowed for over-pouring and spillage as follows: 12 percent for liquor, 10 percent for draft beer, and 6 percent for wine.

[11] As used in this Opinion, "pour" refers to the amount of alcoholic beverage poured into the serving container.

[12] Appellant claims it offered 2-for-1 prices for all alcoholic beverages during happy hour.

respondent computed audited markups of 442.69 percent for straight liquor drinks, 1,054.76 percent for cocktails, 273.54 percent for bottled beer, 238.65 percent for draft beer, and 124.75 percent for wine.

11. Respondent used the sales recorded on appellant's Cost Analysis Report to compute the following percentages of liquor and beer drinks by category: 61.75 percent straight drinks, 38.25 percent cocktails, 67.65 percent bottled beer, and 32.35 percent for draft beer.

12. Respondent used those ratios and the audited markups of 442.69 percent for straight drinks and 1,054.76 percent for cocktails to compute a weighted markup for liquor of 676.81 percent. It used the ratios and the audited markups of 273.54 percent for bottled beer and 238.65 percent for draft beer to compute a weighted markup for beer of 262.25 percent.[13]

13. Respondent used the limited information provided by appellant and information that respondent obtained directly from some of appellant's vendors to establish audited purchases. To establish the audited cost of beer sold, respondent reduced the purchases of bottled beer identified by the vendors by 1 percent for breakage, added that figure to draft beer purchases, reduced the total by 6 percent for the cost of self-consumed beer, and reduced the balance by 2 percent for pilferage. To establish the audited cost of liquor and wine sold, respondent first totaled the purchases of liquor, wine, water, and mixers identified by the vendors. Respondent reduced that total by 10.68 percent to remove water and mixers.[14] Respondent reduced the purchases of liquor and wine by 6 percent for the cost of self-consumed liquor and wine and reduced the balance by 2 percent for pilferage. It multiplied the remainder by 94.86 percent to compute the audited cost of liquor sold and by 5.14 percent to compute the audited cost of wine sold.[15]

14. For the period 2Q09 through 3Q10, respondent added the calculated weighted markups of 262.25 percent for beer, 676.81 percent for liquor, and 124.75 percent for wine to the

[13] Respondent did not calculate a weighted markup for wine.

[14] The 10.68 percent was calculated using the merchandise purchase invoices for January and February 2011.

[15] The 94.86 percent and 5.14 percent were calculated by respondent in the purchase segregation.

audited cost of goods sold (COGS) in each category to compute audited taxable sales of $912,604 for alcoholic drinks for that period.

15. Using appellant's Cost Analysis Report, respondent determined that sales of alcoholic drinks represented 80.66 percent of appellant's taxable sales, which included sales of non-alcoholic beverages and food. Respondent therefore divided the audited sales of alcoholic drinks of $912,604 by 0.8066 to compute audited taxable sales of $1,131,421 for the period 2Q09 through 3Q10.[16]

16. Respondent deducted reported taxable sales of $129,583 for that period to compute an understatement of $1,001,838, which represented a percentage of error of 773.12 percent ($1,001,838 ÷ $129,583).

17. Respondent noted that application of a percentage of error of 773.12 percent to reported sales for the period 2Q07 through 1Q09, would result in audited taxable sales more than double the audited taxable sales for the period after the business was renovated and reopened as a nightclub. Respondent found that to be an unreasonable result. At the same time, respondent noted that the audited difference for the later period (2Q09 through 3Q10) was greater than the audited amount of excess bank deposits. Therefore, respondent decided in its first reaudit to use a two-step process to establish the audited understatement for the period 2Q07 through 1Q09. Respondent decided to increase the audited amount of excess bank deposits for the period 2Q07 through 1Q09 by the percentage of difference between the audited amount established by markup and the excess bank deposits that it computed for the period 2Q09 through 3Q10.

18. First, respondent calculated excess bank deposits for the period 2Q07 through 3Q10 (the entire liability period).[17] Recorded sales-related deposits for the liability period totaled $1,646,584. Respondent deleted sales tax reimbursement that would have been included in those deposits, calculating recorded sales-related deposits less sales tax reimbursement (ex-tax) of $1,509,630. It then deducted reported taxable sales for the liability period of $438,596 to calculate excess bank deposits ex-tax for the liability period of $1,071,034,

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[16] Respondent accepted appellant's statement that the business was closed for renovation from January 1, 2009, through April 30, 2009, and on that basis assumed there were no sales in April 2009.

[17] This Opinion uses "excess bank deposits" to refer to the difference between recorded sales-related deposits and reported sales.

which is comprised of $349,923 for the period 2Q07 through 1Q09 and $721,111 for the period 2Q09 through 3Q10. Respondent deducted $721,111 from audited taxable sales for the latter period ($1,131,416, determined on a markup basis) to compute the difference of $426,229 between audited taxable sales and excess bank deposits for the period 2Q09 through 3Q10.[18] Respondent then computed that the difference between the audited amount established on a markup basis and the excess bank deposits represented a difference of 59.11 percent ($426,229 ÷ $721,111).

19. As noted above, appellant's excess bank deposits (ex-tax) totaled $349,923 for the period 2Q07 through 1Q09. Respondent multiplied that figure by 59.11 percent to compute the understatement in excess of bank deposits for that period of $206,839.

20. Thus, for the liability period, respondent computed an audited understatement of reported taxable sales of $1,704,099 (rounded), which is the sum of excess bank deposits for the liability period totaling $1,071,034 plus additional understatements on a markup basis of $426,229 (for the period 2Q07 through 1Q09) and $206,839 (for the period 2Q09 through 3Q10).[19]

21. On October 24, 2017, the parties participated in an appeals conference.

22. In a March 27, 2018 Decision, respondent found that a second reaudit was necessary to correct the computation of the audited understatement for the period 2Q07 through 1Q09. First, the Decision found that the difference between the sales established by markup and the excess bank deposits for the period 2Q09 through 3Q10 should be computed by comparing the *unreported* taxable sales based on the markup method (rather than audited taxable sales established on a markup basis, including reported figures) and the excess bank deposits. Then, the Decision found that the revised difference should be used to recompute the percentage of difference between excess bank deposits and the understatement established by markup; and the recomputed percentage should be applied

[18] Audited taxable sales of $1,131,421 - $721,111 = $410,310. The reason for the discrepancy between that amount and the $426,229 is that, for 1Q10, the difference based on bank deposits exceeded the difference established on a markup basis by $15,924. In the first reaudit, respondent regarded the difference based on bank deposits to be the understatement for that quarter. Rather than reducing the understatement for the credit difference, respondent entered zero. One of the changes in the second reaudit (discussed below) was to reduce the difference for the credit amount.

[19] Appellant does not dispute the other audit item, withdrawals from inventory for self-consumption (subject to use tax), measured by $20,406.

to excess bank deposits for the earlier part of the liability period.

23. During the second reaudit, respondent corrected an error in its computation of the understatement for the period 2Q09 through 3Q10. In the second reaudit, respondent applied the correct percentage of error of 773.12 percent to reported taxable sales for that period, instead of the 873.12 percentage of error it had inadvertently applied to reported taxable sales in the first reaudit. Respondent then corrected the difference between the audited understatement established on a markup basis and the excess bank deposits for the period 2Q09 through 3Q10.

24. For the second reaudit, respondent began with its audited understated taxable sales of $1,001,833 for the period 2Q09 through 3Q10, as calculated in the first reaudit.[20] It then deducted excess bank deposits (ex-tax) for the period totaling $721,111 to calculate taxable sales of $280,722 (in addition to those represented by excess bank deposits). This reduced the error percentage from 59.11 percent (used in the first reaudit) to 38.93 percent, which respondent applied to the excess bank deposits (ex-tax) for the period 2Q07 through 1Q09 to calculate taxable sales of $136,224 (in addition to those represented by excess bank deposits). The resulting second reaudit reduced the audited understatement of reported taxable sales by $216,114 from $1,704,099 to $1,487,985.[21] The unreported cost of self-consumed merchandise of $20,406 remained the same. Using the underreported taxable sales measure of $1,508,391 ($1,487,985 + $20,406), respondent computed tax and penalty of $138,478.17 and $34,619.63, respectively.

25. This timely appeal followed.

DISCUSSION

Issue 1: Is appellant entitled to further adjustments to the audited measure of underreported 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

[20] This amount was calculated by applying the 773.12 error percentage (determined in the markup analysis) to reported taxable sales.

[21] At least one of respondent's schedules from the second reaudit refers to a measure of $1,487,980. The difference appears to be the result of some quarterly amounts differing by $1.00, possibly as a result of rounding. The amount is insignificant and will not be addressed further.

excluded from taxation by statute. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax until the retailer proves otherwise. (R&TC, § 6091.) Although gross receipts from the sale of "food products" are generally exempt from sales tax pursuant to R&TC section 6359(a), the exemption does not apply to sales of alcoholic or carbonated beverages (R&TC, § 6359(b)(3)), to sales of food served in a restaurant (R&TC, § 6359(d)(1)), or to sales of hot food to-go (R&TC, § 6359(d)(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 records necessary to determine the correct tax liability, including bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When a taxpayer appeals a deficiency determination based on underreported taxable sales, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met that burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid*.) Proof of error in respondent's analysis generally will not be sufficient to satisfy a taxpayer's burden of proof; the taxpayer must also prove the correct tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c); *Appeal of Estate of Gillespie*, 2018-OTA-052P.) That is, the taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, *supra*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.)

Appellant reported sales of only $438,596 for the liability period. This translates to average monthly sales of $11,542 ($438,596 ÷ 38 months of operation = $11,542), average nightly sales of $721 ($11,542 ÷ 16 nights of operation per month), and average hourly sales of $144 ($721 ÷ 5 hours of operation). With regular beer prices of $4.00 or $5.00 and regular

cocktail prices from $8.00 to $12.00, sales of $144 per hour is not credible.[22] These average hourly sales would be even lower for those weeks during which appellant operated more than four nights. In addition, appellant did not provide business records that were adequate for sales and use tax purposes. Given these circumstances, respondent's decision to pursue the audit using an indirect audit method was reasonable and rational. The work papers from the original audit and two reaudits show that respondent applied sound and rational audit methodologies to purchase, sales, and bank deposit data contained in the available business records to calculate a reasonable estimate of appellant's underreported taxable sales. The evidence thus establishes a reasonable and rational basis for respondent's determination. Therefore, the burden is on appellant to prove that it is entitled to further adjustments.

Appellant argues that respondent misunderstands appellant's business model as one targeting a middle to high-end clientele when, in fact, it targeted the college-age crowd, who were interested in purchasing cheap drinks in volume. Appellant asserts that it catered to these customers by offering low-priced drink specials for much of the night, and it contends that respondent arbitrarily picked the percentages of sales at regular prices and happy hour and in the process underestimated the percentage of happy hour sales. Appellant also states that its bartenders did not measure liquor pours, but rather free-poured generous quantities. It disputes the 1.75-ounce pour size used to compute the markups for straight liquor drinks and argues that the allowance for spillage should be higher than 12 percent. Appellant also argues that the markup for straight liquor drinks and cocktails should be the same. Appellant also asserts that the computation of the audited COGS should include an adjustment for ending inventory. Appellant disagrees with the audit methodology in general and specifically argues that bank deposits included non-sales income and that respondent's use of the markup methodology and a bank deposit analysis could have caused respondent to count sales twice.

Appellant also raised several new arguments at the hearing. It argues that frequent overdraft fees incurred by appellant on its restaurant bank account is evidence that appellant was not failing to report substantial taxable sales because, according to appellant's argument, if there was any extra cash available, respondent would not have incurred overdraft charges. Appellant also asserts that respondent relied on unrepresentative data to calculate purchases. Finally, it

[22] According to appellant's sales logs, average hourly sales were $376 in May and $246 in June but averaged less than $100 per hour for the next six months.

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argues that respondent's calculation of weighted markups is flawed because it does not take into consideration the fact that when appellant offered reduced drink prices, which it claims it did frequently, it was depleting its available inventory at an accelerated rate. Appellant argues that sales at reduced prices should be doubled to calculate the percentage of sales.[23]

Most of appellant's arguments find little or no support in the evidence or in the law. There is nothing in the evidence to suggest that respondent established markups or otherwise based its determination on how respondent perceived appellant's business model. The evidence does show that respondent did not arbitrarily guess the percentages of revenue from regular sales and happy hour sales; it used, and appears to have correctly interpreted, appellant's Sales by Category Report.[24] Furthermore, appellant has not proved the claim that it was in the business of furnishing cheap drinks in volume to the college-age crowd.[25] Although appellant asserts that happy hour sales constituted a much greater percentage of its revenue than the percentages shown in its Sales by Category Report,[26] that assertion is not supported by the evidence. Instead, the evidence shows that respondent simply accepted appellant's representations about happy hour specials and incorporated happy hour pricing into the audit and two subsequent reaudits.[27] Respondent did not require transaction-level (source) documents (e.g., guest checks or cash register receipts) to verify the information. In this appeal, though, evidence drives the analysis, and the evidence does not support appellant's claims of wide-scale and frequent two-for-one pricing.

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[23] Appellant made several arguments in its briefs and several new arguments at the hearing. Although appellant stated at the hearing that it has changed or abandoned one particular argument made in an earlier brief, it did not expressly waive or withdraw the others. Consequently, this Opinion will address all arguments that have not been specifically waived or withdrawn.

[24] The reports provided by appellant constitute its representations of fact. This Opinion's references to or reliance on data contained in the reports are not testaments to the accuracy of those reports in their entirety.

[25] Selling cheap drinks to customers in their early twenties seems inconsistent with appellant's claim that it regularly collected substantial sums – an average of over $1,400 per night in August 2009 – from its customers for room rentals.

[26] The report shows 20.53 percent of liquor sales, 29.93 percent of beer sales, and 11.11 percent of wine sales were at happy hour prices.

[27] The Sales by Category Report for the period May 1, 2011, through June 15, 2011 (the only period for which appellant provided that report) was used to compute percentages of sales at regular prices and at happy hour prices. The Sales by Category Report is for a period at least seven months after the liability period and is not supported by source documents or data.

Appellant's Cost Analysis Report, which purports to list sales during the period March 1, 2011, through March 15, 2011, refers to just three drink specials: a $5 premium liquor drink special, of which appellant sold five (.47 percent of total sales) during the 15-day period, a $3 beer special, of which appellant sold 61 (3.44 percent of total sales) during that period, and a $4 beer special, of which appellant sold 34 (2.56 percent of total sales) during that period. Appellant would have been open at least eight of the 15 days in the period reported. Those numbers do not indicate long happy hours or substantial happy hour sales, which is consistent with a review on appellant's Facebook page from July 4, 2010, when the business was purportedly serving $3.00 Kamikazes and $3.00 Bud Light beers.[28]

The evidence also does not support appellant's claims that it poured more than 1.75 ounces of liquor into straight drinks or more than 2.43 ounces of liquor and liqueur into mixed drinks, or its claim that respondent's allowance for liquor spillage was too low at 12 percent. Appellant did not state its standard pour amount on the Bar Fact Sheet. Respondent used reasonable pour amounts: a 1.75-ounce pour for straight liquor drinks and a 2.43-ounce pour for cocktails.[29] Respondent had already increased the straight liquor pour from 1.5 ounces to 1.75 ounces based on appellant's unsupported assertion that 2-ounce pours were routine. The 2.43-ounce cocktail pour is based on appellant's cocktail recipes. Appellant has provided no persuasive evidence to support its claim that either pour should be larger. The 12 percent spillage allowance was also reasonable. It is consistent with respondent's Audit Manual section 0806.42, and appellant has provided no evidence to support its claim that the allowance should have been larger.[30] Therefore, no adjustments in these areas are warranted.

While it is correct that a markup analysis based on complete and accurate records may

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[28] According to the Cost Analysis Report, Bud Light regularly sold for $4 or $5 – both prices are listed – Kamikazes (a shot containing vodka, lime juice, and orange liqueur) regularly sold for $10, and appellant sold three Kamikazes from March 1 through March 15, 2011.

[29] Respondent originally used a 1.5 ounce pour in its calculations, consistent with its Audit Manual's direction. According to the Report of Discussion of the original audit, appellant objected, claiming that it regularly used a 2 ounce pour. Respondent compromised and changed that measurement to a 1.75 ounce pour.

[30] 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 OTA 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.)

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take both a beginning and an ending inventory into consideration,[31] appellant's argument that respondent's markup analysis fails to consider appellant's ending inventory ignores the fact that appellant provided no detailed inventory counts for the beginning or end of the liability period. Appellant opened its seller's permit in September 2001, and it should have had an existing inventory on April 1, 2007, the beginning of the liability period. Since the evidence does not include reliable beginning or ending inventory amounts, it was reasonable for respondent to assume the inventory remained relatively constant and not take beginning or ending inventories into account. No ending inventory adjustment was necessary or appropriate.

This Opinion has already concluded that respondent's decision to pursue the audit using an indirect audit method was reasonable and rational, and that respondent applied rational audit methodologies to the limited purchase, sales, and bank deposit data contained in the provided business records to calculate a reasonable estimate of appellant's underreported taxable sales.

Regarding appellant's argument that the bank statements may reflect deposits of funds from sources other than sales, the understatement was not calculated using a bank deposit analysis in the traditional sense. As explained above, the understatement was calculated using a hybrid analysis that used the markup method and bank deposits to calculate a percentage of error based on the difference between the markup computations and the excess bank deposits for the period 2Q09 through 3Q10. In this analysis, the effect of a reduction to the deposits from taxable sales during that period is the opposite of what appellant appears to argue. If the amount of sales reflected by the bank deposits is reduced, the difference between the markup computations and the excess bank deposits would *increase*. Thus, the percentage of error based on that difference, which would be applied to the excess bank deposits for the period 2Q07 through 1Q09, would increase, as would appellant's liability. While less excess bank deposits during the earlier part of the liability period would impact the understatement, appellant has had years to provide evidence of deposits unrelated to sales but has not done so. No adjustment on this basis is warranted.

Regarding appellant's argument that the understatement is excessive because respondent has added the excess bank deposits and the understatement established by the markup method, which may have caused at least some taxable sales to be counted twice, respondent did not

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[31] The COGS equals the beginning inventory plus purchases less ending inventory.

establish understatements by two separate methods and then add them together. The audit methodology was designed and executed to provide a reasonable estimate of appellant's taxable sales without counting any such sales more than once. Appellant has not shown otherwise. Therefore, no adjustment on this basis is warranted.

Appellant raised three new arguments at the hearing. The first argument is that incurring overdraft fees proves the account holder does not have funds with which it could have covered the draft(s). This is a baseless argument, which will not be addressed further in this Opinion. The second argument is that respondent used unrepresentative purchase data in its markup analysis. Appellant offered testimony regarding products used in the shelf test and argued that some of the products were rarely used. However, respondent used the available information. Had appellant kept the required records and provided those to respondent, more products, and perhaps more representative products, could have been included. Also, appellant could have done its own shelf test and provided the appropriate documentation to OTA for its consideration. It did not do that. No adjustment is warranted on either ground.

Appellant's third new argument is that respondent's markup analysis for sales of alcoholic beverages fails to fairly consider the cost of products sold at regular and happy hour or other reduced prices. In other words, appellant asserts that when the markup is lower, as it is for all reduced-price drinks, more product is transferred per revenue dollar. Consequently, appellant contends that a weighted markup more accurate than the one used by respondent must be calculated using the cost of product transferred. Appellant proposes that the weighted markups be recalculated by doubling the sales amounts during happy hour as shown on appellant's Sales by Category Report. Thus, happy hour liquor sales would be increased from $6,198.33 to $12,396.66; happy hour beer sales would be increased from $4,245.10 to $8,490.20; and happy hour wine sales would be increased from $91.10 to $182.20. These changes would result in reductions to the weighted average markups and a reduction to the measure of tax.

Respondent argues that it determined the weighted average markup for alcoholic beverages in the manner prescribed by its Audit Manual and that allowing reduced price sales based only on appellant's unsupported assertions resulted in a "very favorable weighted markup percentage."[32] Respondent also acknowledges that there may be ways to accurately calculate

[32] Because appellant did not raise this argument before the hearing, respondent was given an opportunity to reply in a post-hearing brief.

weighted markup averages based on purchases that are not discussed in its Audit Manual, but respondent cautions that "those methods would have to be estimated based on certain criteria and may not be as accurate as the methods prescribed in the Audit Manual." Respondent does not specifically address the methodology appellant proposes.

Appellant's argument is best addressed in two parts, the second part only being required if the first part is decided in appellant's favor. The first part of the analysis will compare the competing methodologies to determine which is likely to produce the most accurate result. If it is decided that the methodology proposed by appellant is likely to produce the more accurate result, the second part of the analysis will determine whether there is sufficient evidence to employ the methodology and, if there is, whether use of that methodology is likely to lead to a result favorable to appellant.

A comparison of the methodologies appears to support appellant's argument. The determination was made using a markup analysis based in part on appellant's purchases of alcoholic beverages for sale to its customers. In other words, respondent determined how much product was available for sale and appellant's cost for that product, and it then determined the price appellant received when it sold the products. The analysis may be demonstrated using the following hypothetical facts: (1) the COGS is $300,000; (2) a test of $6,000 in sales shows that $5,000 (83 percent) was generated from sales at a 400 percent markup, and $1,000 (17 percent) was generated from sales at a 150 percent markup. The weighted average markup is 358 percent (rounded). (.83 x 4.00 = 3.32; .17 x 1.50 = .255; 3.32 + .255 = 3.575.)

Respondent would calculate sales totaling $1,374,000 ($300,000 x 4.58 = $1,374,000), consisting of regular priced sales of $1,140,420 ($1,374,000 x .83 = $1,140,420) and reduced-price sales of $233,580 ($1,374,000 x .17 = $233,580). To compute the cost of the sales at regular and reduced prices, revenue at each price level is divided by the markup to determine that goods costing $228,084 were sold at a 400 percent markup ($1,140,420 ÷ 5.00 = $228,084) and good costing $93,432 were sold at a 150 percent markup ($233,580 ÷ 2.50 = $93,432). So, although the analysis began with a COGS of $300,00, the calculated cost of the goods sold for $1,374,000 is $321,516 ($228,084 + $93,432 = $321,516), or $21,516 more than was available.

Appellant's proposed methodology, which uses the COGS to calculate the percentage of sales at the two price levels, produces a more accurate result, though appellant's recommended calculation is not the correct one. The correct calculation, using the same hypothetical facts,

would be more like the following: (1) goods sold at a 400 percent markup for $5,000 cost $1,000 ($5,000 ÷ 5.00 - $1,000), and (2) goods sold at a 150 percent markup cost $400 ($1,000 ÷ 2.50 = $400). The percentage of products sold at regular and reduced prices would be approximately 71 percent ($1,000 ÷ $1,400 = .7142) and 29 percent ($400 ÷ $1,400 = .2857), respectively. The weighted average markup would be 327 percent. (.71 x 4.00 = 2.84; .29 x 1.50 = .43; 2.84 + .43 = 3.27.) Using appellant's proposed methodology, sales at the regular price would be $1,065,000, which is 71 percent of the total COGS (.71 x $300,000 = $213,000) at a 400 percent markup (213,000 x 5.00 = $1,065,000); sales at the reduced price would be $217,500, which is 29 percent of the total COGS (.29 x $300,000 = $87,000) at a 150 percent markup (87,000 x 2.50 = $217,500); and total sales would be $1,282,500, which is $91,500 less than the amount determined using respondent's methodology. Because the calculation uses COGS to determine the percentage of goods sold at each price level, the COGS at the two levels combined equals $300,000. Thus, appellant's proposed methodology is likely to produce the more accurate result.

Having determined that the methodology proposed by appellant is likely to produce the more accurate result, the next question is whether the evidence will support application of that methodology. The proper application of appellant's proposed methodology requires sufficient evidence to reliably determine at least COGS and the percentage of sales of the various categories of alcoholic beverages at regular and reduced prices, based on COGS. Respondent argued at the hearing, and again in its post-hearing brief, that the required evidence is not in the record. Appellant does not address the issue and appears to base its arguments on the percentages shown in its Sales by Category Report.

As already stated, the few records appellant provided are not sufficient for sales and use tax purposes. Respondent obtained some records of purchases directly from some of appellant's vendors, but the evidence indicates that all purchases are not shown in the evidence. Furthermore, as explained earlier in this Opinion, there is scant evidence that appellant made substantial sales at reduced prices. Appellant's Sales by Category Report is not supported by source documents or by appellant's Cost Analysis Report, and the fact that respondent was willing to accept unsupported assertions in support of appellant's claims that it made substantial reduced-price sales does not relieve appellant of the burden of proving here that such sales occurred. As already stated, above, appellant has the burden of proving that a result different

from respondent's determination is warranted. (*Appeal of Talavera*, *supra*.) Proving that respondent erred in its determination is not enough; appellant must prove the proper amount of tax. (*Appeal of AMG Care Collective*, *supra*.)

Thus, while appellant has made a valid argument concerning how the markup methodology should be applied under the circumstances presented here, there is inadequate evidence of reduced-price sales to warrant application of appellant's proposed methodology. Without that evidence – or a stipulation by the parties – OTA cannot simply apply the methodology without examining the adequacy of the underlying evidence. When a taxpayer does not provide complete records, and respondent must therefore utilize indirect audit methods, the audit, by definition, relies on testing and estimates that are based on the best available information. As a result, respondent sometimes agrees to accept unsupported assertions by a taxpayer. At times, respondent offers a compromise, as it did in this case when it increased the straight liquor pour size from 1.5 ounces to 1.75 ounces after appellant claimed to use 2-ounce pours. The taxpayer might also be the one to propose a concession or compromise. OTA views these concessions or compromises in the context in which they occurred. The fact that respondent was willing to allow adjustments in the audit for the alleged two-for-one pricing does not prevent respondent from arguing here, as it did at the hearing, that the evidence does not support allowances for reduced-price sales. OTA would take a similar view of a taxpayer's concession or compromise made in the context of an audit. What is important in such situations is that the parties have adequate notice regarding contested matters and a reasonable opportunity to be heard. Appellant had both.

Appellant has not proved a more correct measure of tax. Consequently, it is not entitled to further adjustments to the audited measure of underreported taxable sales.

Issue 2: Has fraud been established by clear and convincing evidence?

In the case of a deficiency determination, a penalty of 25 percent of the amount of the determination applies if any part of the deficiency is due to fraud or an intent to evade the law or any authorized rules or regulations. (R&TC, § 6485.) Fraud or intent to evade must be established by clear and convincing evidence. (Cal. Code Regs, tit. 18, § 1703(c)(3)(C); see, e.g., *In re Renovizor's Inc. v. BOE* (9th Cir. 2002) 282 F.3d 1233, 1241). The express language of R&TC section 6485 makes it clear that a fraud penalty shall be imposed on the entire deficiency "if any part" of that deficiency determination is due to fraud.

The R&TC does not define fraud, but there are precedents that provide guidance. It is an unusual case that involves evidence tantamount to a "smoking gun." Instead, triers of fact often look to badges of fraud or other circumstantial evidence to support a finding of a taxpayer's intent to evade tax. (*Bradford v. Commissioner* (9th Cir. 1986) 796 F.2d 303, 307.) Such badges of fraud may include an understatement of income, inadequate records, failure to file tax returns, implausible or inconsistent explanations of behavior, concealment of assets, failure to cooperate with tax authorities, and lack of credibility in the taxpayer's testimony. (*Appeal of ISIF Madfish, Inc.*, 2019-OTA-292P.) While a failure to report income may not alone be sufficient to warrant a finding of fraud, repeated understatements in successive years, coupled with other circumstances showing intent to conceal or misstate taxable income, may support a fraud finding. (*Ibid.*)

The evidence shows that appellant did not maintain and provide adequate records. The records that it did provide were not supported by source documents, were internally inconsistent, and were inconsistent with the facts as found in this Opinion. This indicates that appellant manipulated its records to hide sales. Appellant did not provide federal income tax returns for examination and admitted that it had not filed any for the years requested. Appellant failed to report a taxable measure of $1,508,391 ($1,487,985 understatement of reported taxable sales + $20,406 unreported cost of self-consumed merchandise) over fourteen quarters.[33] That understatement represents an error rate of 344 percent ($1,508,391 ÷ $438,596 reported). For every dollar of taxable sales that appellant reported, it failed to report $3.44. It reported just over 22 percent of its taxable sales. This is strong evidence that appellant was aware of all of its failures, and this evidence of fraud or intent to evade tax is clear and convincing. Consequently, respondent has met its burden of proof.

Appellant alleges that the penalty is based primarily on the deficiency amount and that, while the fraud penalty may have been warranted based on the results of the initial audit, the liability has since been reduced and no longer warrants the penalty. Appellant also claims that it delegated sales tax matters to an "unrelated third-party practitioner who was not an employee of [appellant]," apparently referring to its former accountant; appellant alleges that its former accountant had all of the books and records and simply misinterpreted the law. Appellant asserts that the accountant died, apparently without returning appellant's records. Finally, appellant

[33] The business was closed for renovations during four months of that time.

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refers to respondent's three audits and argues that respondent's alleged inability to correctly determine the tax essentially negates the possibility that fraud can be established by clear and convincing evidence.

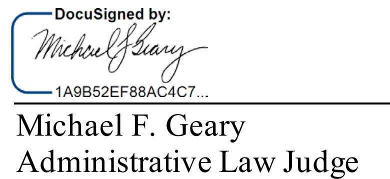
Appellant's counterarguments are unpersuasive. First, the audit and two reaudits all determined that appellant consistently and substantially underreported its taxable sales throughout the liability period. As already stated, the amount of the deficiency determined in the second reaudit is evidence, though not the only evidence, of fraud. Second, there is no credible evidence that anyone other than appellant is responsible for appellant's failure to maintain and provide complete and accurate business records or its failure to accurately report its tax liabilities. Finally, respondent resorted to indirect audit methodologies to estimate appellant's sales because appellant failed to maintain and provide adequate records; and the subsequent reaudits appear to have been calculated to address appellant's concerns about, and to correct errors discovered in, the preceding audit. The adjustments to the taxable measure do not detract from the clear and convincing evidence of fraud.

HOLDINGS

1. Appellant is not entitled to further adjustments to the audited measure of underreported taxable sales.
2. Fraud has been established by clear and convincing evidence.

DISPOSITION

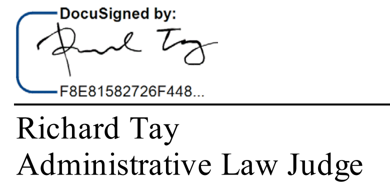
Respondent's decision to reduce the audited tax deficiency to $138,478.17, to reduce the fraud penalty to $34,619.63, and to deny the remainder of the petition is sustained.



Michael F. Geary
Administrative Law Judge

We concur:

Daniel K. Cho
Administrative Law Judge



Richard Tay
Administrative Law Judge

Date Issued: 9/27/2022