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2023 – OTA – 338
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No.: 21037383
	)	CDTFA Case ID: 389-178
J. PADILLA,	)	
dba Uruapan Restaurant Bar & Grill	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellant: David Pidal, Representative

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

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

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, J. Padilla (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] in response to appellant's petition for redetermination of the Notice of Determination (NOD) dated September 19, 2018. The NOD is for tax of $452,310.00, plus applicable interest, and a negligence penalty of $45,231.04, for the period April 1, 2011, through March 31, 2014 (audit period). In its subsequent decision, CDTFA reduced the tax from $452,310.00 to $277,804.00; reduced the penalty from $45,231.04 to $27,780.45; and denied the remainder of the petitioned amount.

Office of Tax Appeals (OTA) Administrative Law Judges Michael F. Geary, Andrew J. Kwee, and Josh Aldrich held an oral hearing for this matter in Cerritos, California, on February 16, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

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

ISSUES

1. Whether further adjustments are warranted to the determined measure of tax.
2. Whether the negligence penalty was properly imposed.

FACTUAL FINDINGS

1. Appellant has operated a full-service Mexican-style restaurant and bar in Baldwin Park, California, since August 2009. The restaurant offers live entertainment, and appellant also offers catering services.
2. During the audit period, appellant reported total sales of $8,023,535, claimed a deduction for sales tax included of $657,613, and reported taxable sales of $7,365,922.
3. For audit, appellant provided federal income tax returns (FITRs) for 2011 and 2012; sales and use tax returns (SUTRs) for the period from the second quarter of 2011 (2Q11) through 2Q13; daily handwritten sales worksheets and monthly sales summaries for the period 2Q11 through 2Q13; bank statements from 2Q11 through July 2013; point of sale (POS) summary reports for May 2014 and June 2014; and Forms 1099-K[2] for 2011 through 2013.
4. According to CDTFA's audit workpapers, appellant stated that he transcribed his daily sales from the POS records to the handwritten daily sales worksheets and then used the monthly totals of the handwritten worksheets to prepare SUTRs.
5. Appellant also stated that he was unable to provide POS records for any period prior to May 2014 because his POS system crashed in April 2014.
6. In its preliminary review, CDTFA found that there were minor differences between the sales reported on appellant's SUTRs and amounts reported on his FITRs and amounts recorded on the handwritten monthly sales worksheets.
7. CDTFA used the total sales and costs of goods sold reported on appellant's FITRs to compute book markups[3] of 132 percent for 2011 and 135 percent for 2012 (rounded),

[2] Form 1099-K is an Internal Revenue Service form which shows amounts paid to the merchant by customers using some type of payment card (i.e., credit card or debit card) or third-party network (e.g., PayPal).

[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 $.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

which were significantly lower than the markup of at least 300 percent that CDTFA expected for a restaurant with a full bar.

8. CDTFA concluded that further investigation was warranted and decided to utilize the credit card projection of sales audit method to establish audited taxable sales. CDTFA also obtained additional Form 1099-K data from internal sources.
9. CDTFA compared Form 1099-K data and bank deposits, which revealed that appellant had not deposited at least $274,884 in credit card payments into the bank account for which appellant had provided records. CDTFA interpreted the material difference as an indication that not all bank statements had been made available; thus, CDTFA determined that appellant's bank statements were unreliable. Also, appellant stated that he used cash receipts to pay vendors and to pay tips to his employees on a daily or regular basis.
10. CDTFA used appellant's POS records for May 2014 and June 2014 to compute an audited ratio of credit card sales to total sales of 43.63 percent.
11. CDTFA used the Form 1099-K data to compute total credit card receipts, excluding tax and tips,[4] of $5,415,898 for the audit period. CDTFA divided that figure by 0.4363 to compute audited taxable sales of $12,413,243, which exceeded reported taxable sales of $7,365,922 by $5,047,321.
12. CDTFA concluded that the understatement was the result of negligence because appellant did not provide adequate records and the amount of the understatement was substantial.
13. On September 19, 2018, CDTFA issued the NOD for tax of $452,310.00, plus applicable interest, and a negligence penalty of $45,231.04.
14. On October 17, 2018, appellant filed a petition for redetermination.
15. CDTFA conducted a revised audit in which it increased the audited amount of credit card sales.[5] Since CDTFA discovered additional Form 1099-K data, the audited amount of credit card sales was increased. The audited credit card ratio of 43.63 percent remained the same.

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[4] In this computation, CDTFA computed tips using an estimate of 10 percent.

[5] CDTFA indicated that a revised audit was conducted because the auditor found two additional bank merchants that had not been included in the original audit. Therefore, the auditor revised the audit to include the Form 1099-K data for those two bank merchants (Wells Fargo Bank and First Data).

16. On May 6, 2019, CDTFA issued a notice of increase[6] related to the revised audit, which reflected an increase in tax from $452,310.00 to $570,291.00, and an increase in the penalty from $45,231.04 to $57,029.13.
17. After the CDTFA appeals conference held on February 4, 2020, appellant provided additional documentation, which showed that some of the Form 1099-K data used by CDTFA to establish total credit card sales represented sales made by another business owned by appellant. Appellant provided documents for Merrick Bank accounts, Wells Fargo Merchant Services LLC accounts, and First Data Merchant Services Corporation accounts. While the address on the Wells Fargo accounts and First Data accounts is the same as appellant's address, the payee name or the "doing business as" name is that of appellant's other business. Since appellant had two other Merrick accounts that were utilized by the business under audit, CDTFA concluded that the third Merrick account pertained to appellant's other business.
18. On October 5, 2020, CDTFA issued a decision ordering a reaudit to reduce appellant's total credit card sales by $1,712,516. The $1,712,516 represents credit card sales from the Wells Fargo Accounts, the First Data Accounts, and one of the Merrick Accounts. The decision did not order a change to the audited credit card ratio. Further, the decision concluded that the understatement was the result of negligence.
19. CDTFA prepared the reaudit, which reduced the amount of tax from $570,291.00 to $277,804.00 and reduced the penalty from $57,029.13 to $27,780.45.
20. This timely appeal followed.

DISCUSSION

Issue 1: Whether further adjustments are warranted to the determined measure of tax.

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC,

[6] The notice of increase was timely because it was issued before the determination became final and was issued within three years following the date of the NOD. (R&TC, § 6563(a)(1).)

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§ 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)1).)

If CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Amaya*, 2021-OTA-328P.) If CDTFA meets its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) The burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

In general, sales of food are exempt from tax. (R&TC, § 6359.) However, the exemption does not apply to all sales of food. As relevant here, sales of food are subject to tax if the food is sold for consumption at facilities provided by the retailer or if the food is sold as hot prepared food products. (R&TC, § 6359(d)(2), (d)(4), and (d)(7).)

Here, appellant provided incomplete books and records. After reviewing appellant's records, CDTFA determined that additional investigation was warranted based on the lower- than-expected book markup (131.67 percent for 2011 and 134.69 percent). CDTFA used appellant's May 2014 and June 2014 POS records to calculate an audited credit-card-sales-ratio. CDTFA computed audited total taxable sales by applying the credit-card-sales-ratio to the 1099- K data after netting out the sales tax reimbursement and tips. Subsequently, CDTFA reduced the audited taxable measure to address 1099-K data that had been erroneously included.

The credit-card-sales-ratio method is a recognized and accepted accounting procedure. (See *Appeal of Amaya*, *supra*.) Under these circumstances, OTA finds CDTFA's use of an indirect audit method was reasonable and rational. OTA further finds that the credit card projection of sales was an appropriate approach for this audit. Accordingly, OTA finds that CDTFA has shown that its determination is reasonable and rational; thus, the burden of proof shifts to appellant to establish a more accurate taxable measure.

Appellant argues that an audited credit card ratio of 44 percent is too low. Appellant contends that, in a full-service restaurant and bar, cash sales would not be 56 percent of total sales or higher. To support a higher credit card ratio, appellant provided his POS records for May 2020, which show a credit card ratio of 51.83 percent. Appellant acknowledges that May 2020 was in the middle of the pandemic and notes that the restaurant's sales had significantly declined from the amounts of sales during the audit period. However, appellant argues that the data from May 2020 should be combined with the credit card ratios for May 2014 and June 2014 to compute an audited credit card ratio of 46.36 percent (43.82 percent for May 2014 + 43.42 percent for June 2014 + 51.83 percent for May 2020 = 139.07. 139.07 ÷ 3 = 46.36 percent).

In support, appellant provided a map that shows two locations: (A) appellant's business address and (B) the business address of another restaurant within five miles of appellant's business (Location B). Appellant claims that restaurant at Location B is also a Mexican-style restaurant and bar. Appellant also provided a schedule that he claims is from the audit of the business at Location B. According to the schedule, CDTFA calculated a credit-card-sales ratio of 59.91 percent for the business at Location B.

In response, CDTFA argues that, if the May 2020 sales information is used, the average percentage should be a weighted average, which CDTFA computes at 44.34 percent.

Regarding appellant's argument that data from May 2020 should be incorporated into the computation of the audited credit card ratio, OTA begins with a general observation. Typically, the reliability of audit findings increases when additional data is reviewed (i.e., a credit card ratio computed for one month is more reliable than a ratio computed for one day because credit card ratios vary each day). However, the general observation only holds true if all the data tested is representative of the period under review.

Here, the audit schedule for Location B appears to be based on a bank deposit analysis. In this audit, however, the bank deposits were unreliable based on the material difference between credit card bank deposits and total credit card sales for the audit period. Also, appellant's practice of regularly using cash to pay vendors or pay his servers tips detracts from the reliability of a bank deposit analysis. Assuming for the sake of argument appellant's business and that of Location B are substantially similar, a single schedule from an audit of a nearby Mexican-style restaurant does not contain enough information to make an informed

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comparative analysis. For example, OTA cannot review audit information for Location B such as: the date of the observation, if applicable; whether there were material differences between Location B's records; and whether complete POS records were provided.

Regarding the credit-card-sales ratio, the audit period ended in March 2014. The months of May and June 2014 were in the following quarter. As a result, it is more likely than not that the credit-card-ratios computed for those two months were representative of the ratios during the audit period. Moreover, appellant did not provide POS records for any months during the audit period. Accordingly, the records for the months of May and June 2014 offered the best available evidence of the credit-card-ratio during the audit period. OTA also observes that CDTFA used appellant's own records for two full months of operation to compute the audited credit card ratio. That test is sufficiently long to provide a reliable result, and appellant has not offered evidence, or even argument, that his records for May and June 2014 were incorrect. In addition, the credit-card-sales ratios for the two months were nearly identical, 43.82 percent for May 2014 and 43.42 percent for June 2014. That similarity further supports that the audited credit-card-sales ratio of 43.63 percent is representative of appellant's business operations during the audit period.

In contrast, the month of May 2020 was approximately six years after the end of the audit period. Even more significantly, May 2020 was in the middle of the COVID-19 pandemic. Restaurant operations were entirely different during that period than they were in 2014. Many restaurants were only open for take-out and delivery. Logically, if a restaurant with a full bar were only open for take-out and delivery, its bar sales would be substantially reduced. Also, given the communicable nature of COVID-19, many businesses and individuals preferred to use credit cards instead of handling cash. Accordingly, OTA finds that the business climate in May 2020 was entirely different from the audit period. OTA, therefore, finds it is not appropriate to incorporate data from May 2020 into the computation of the audited credit card ratio. Thus, OTA finds that appellant has not shown that adjustments are warranted to the determined measure of tax.

While the foregoing is dispositive, OTA also notes that CDTFA has used the available records for 2Q14 to compute audited sales for that quarter (recorded sales for May and June 2014 plus an average of those two quarters, to represent sales for April). CDTFA compared the total for 2Q14, $1,213,832 to reported taxable sales of $859,333 to compute an understatement of $354,499 for the quarter, which represents 41.25 percent of the reported amount. In comparison,

the audited understatement of taxable sales for the audit period of $3,093,470 represents 42 percent of reported taxable sales for the audit period of $7,365,922. OTA finds that the similarity of those percentages supports OTA's earlier finding that the audit findings are reasonable.

Issue 2: Whether the negligence penalty was properly imposed.

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.

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to verify the accuracy of any return filed. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include, but are not limited to, the following: (1) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (2) bills, receipts, invoices, cash register tapes, or other documents of original entry; and (3) schedules of working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and provide complete and accurate records will be considered evidence of negligence or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

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

Appellant argues that he did not have expertise in preparing sales and use tax returns and maintaining books and records. Appellant asserts that, while another business he owned was previously audited, that business was not a restaurant. Instead, the other business was a grocery market and, therefore, not comparable to a restaurant-bar. Appellant states that he did not use a

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POS system in the other business.[7] Appellant also argues that English is his second language, which he attributes as the reason he did not understand the record keeping requirements.

CDTFA argues that the understatement was the result of negligence because appellant failed to provide complete records, and because reported taxable sales were substantially understated. CDTFA notes that, while this business had not been audited previously, appellant owns another business that was previously audited. CDTFA concludes, therefore, that appellant had sufficient experience and knowledge to properly report his taxable sales. Furthermore, CDTFA argues that it offers information and assistance in Spanish, both in written and oral format. Therefore, CDTFA asserts that appellant's second language argument lacks merit.

OTA notes that appellant says he transcribed sales from the POS records to handwritten daily and monthly summaries. He then presented those unsupported handwritten summaries as the only available evidence of sales. Appellant did not provide any detailed records of purchases or other business expenses, and he provided no records of cash used to pay expenses or otherwise withdrawn from the business without being deposited in the bank. OTA finds that appellant's incomplete records are evidence of negligence. Also, appellant's prior experience of an audit, of his grocery market, more likely than not informed appellant of the requirement to maintain complete records and to have them available for audit. Therefore, OTA concludes that appellant could not have had a bona fide and reasonable belief that his bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law.

In addition to the fact that appellant did not provide complete records as required by law, the amount of the understatement of reported taxable sales for the audit period is over $3 million. Also, the understatement of $3,093,470 represents an error rate of about 42 percent in comparison to reported taxable sales of $7,365,922. OTA finds that the substantial underreporting is additional evidence of negligence.

Regarding appellant's English as a second language claim, OTA notes that CDTFA offers a significant amount of language resources to the public (e.g., publications, forms, etc.). Also, there is no evidence in the record that appellant was hindered by his knowledge of the

[7] In addition, appellant notes that CDTFA made errors in compiling the credit card receipts from the 1099-Ks. OTA finds that CDTFA's errors, which have been corrected in the reaudit, are not pertinent to OTA's analysis of appellant's negligence, and this Opinion does not address them further.

English language during the audit or appeals process. For example, there are no requests for an interpreter, translated materials, or a translated decision.

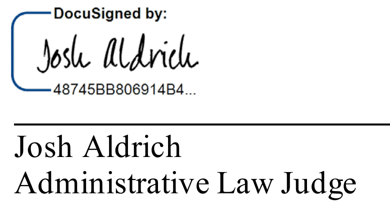
In sum, OTA finds there is evidence of negligence, and the negligence penalty was properly imposed.

HOLDINGS

1. Appellant has not shown that additional adjustments are warranted to the determined measure of tax.
2. The negligence penalty was properly imposed.

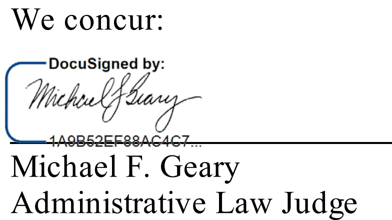
DISPOSITION

Sustain CDTFA's decision to reduce the tax and penalty to $277,804.00 and $27,780.45, respectively, and to otherwise deny the petition.

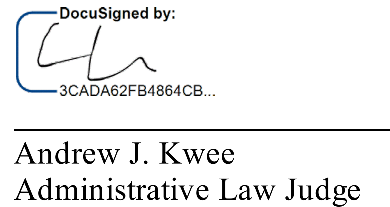


Josh Aldrich
Administrative Law Judge

We concur:



Michael F. Geary
Administrative Law Judge



Andrew J. Kwee
Administrative Law Judge

Date Issued: 5/23/2023