OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 220610548
	) CDTFA Case ID 002-445-264
HUNAN CHILLIKING INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Eddie Cheung, CPA

For Respondent: Jason Parker, Chief of Headquarters Ops.

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

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Hunan Chilliking Inc. (appellant) appeals a Decision, as revised by a Supplemental Decision, issued by respondent California Department of Tax and Fee Administration (CDTFA),[1] which denied appellant's petition for redetermination of a timely-issued Notice of Determination (NOD) dated December 4, 2020.[2] The NOD is for tax of $57,448.00, plus applicable interest, and a negligence penalty of $5,744.81 for the period October 1, 2016, through September 30, 2019 (liability period).

Appellant waived the right to an oral hearing, so the Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUES

1. Whether the determined amount of unreported taxable sales should be reduced.
2. Whether appellant was negligent or intentionally disregarded relevant authorities.

[1] The State Board of Equalization (BOE) formerly administered sales and use taxes. On July 1, 2017, BOE functions relevant to this case transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE.

[2] CDTFA timely issued the NOD because appellant waived the otherwise applicable statute of limitations and consented to extend the deadline for mailing an NOD until January 31, 2021. (See R&TC, §§ 6487(a), 6488.)

FACTUAL FINDINGS

1. Appellant has operated a full-service restaurant specializing in southern Chinese cuisine in San Gabriel, California, since August 2007. During the liability period, appellant offered dine-in and take-out services with minimal sales of beer and wine.
2. Previously, CDTFA had audited appellant for the period of April 1, 2010, through March 31, 2013, finding unreported taxable sales of $945,784. For that audit period, appellant's book markups were 166 percent for 2011, 170 percent for 2012, and 168.38 percent overall.[3] CDTFA computed a credit-card-sales-to-total-sales (credit-card-sales) ratio of 64.91 percent, an overall audited markup of 253.09 percent, and an error rate of 31.56 percent. CDTFA also found that appellant had "suppressed" taxable cash sales.
3. For the liability period, appellant reported total sales of $4,242,238, claimed deductions of $362,118 for sales tax included in reported gross receipts, and reported taxable sales of $3,880,120.
4. For this audit, appellant provided the following books and records: (a) federal income tax returns (FITRs) for 2016, 2017, and 2018; (b) point-of-sale (POS) data and daily transaction printouts for the period of April 1, 2019, through January 31, 2020;[4] (c) credit-card batch reports for the period of August 12, 2019, through August 18, 2019; (d) bank statements for the liability period; (e) merchant statements for the liability period; and (f) purchase invoices for paid bills and fixed assets.
5. Before the audit began in October 2019, CDTFA staff made three unannounced purchases at appellant's restaurant: two on September 20, 2019 (one paid by credit card and one paid by cash), and one on September 26, 2019 (paid by cash). CDTFA traced the transactions to appellant's POS records and found that the one credit-card sale had been recorded but the two cash sales had not.
6. On the dates of these unannounced purchases, CDTFA staff observed a sign, posted at the location of the restaurant's register, that stated, "CREDIT CARDS

[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 (0.30 ÷ 0.70 = 0.42857). A "book markup" is one that is calculated from the retailer's records.

[4] Appellant began using a new POS system in the second quarter of 2019.

ACCEPTED with $25 MINIMUM PURCHASE." During the audit, appellant removed the sign and repeatedly denied that it only accepted credit cards for sales of $25 or more. However, CDTFA had taken a photo of the sign on September 20, 2019, which is included in the record.[5]

7. In its review of appellant's bank statements, CDTFA noted that appellant did not deposit any cash in the bank for 32 of the 36 months of the liability period. For the four months that appellant deposited cash in the bank—February, April, June, and July of 2017—the deposits were $9,000, $20, $5,000, and $18,468, respectively.

8. CDTFA computed that appellant's credit-card receipts represented approximately 83 percent of appellant's reported taxable sales for the liability period. Per its audit working papers, CDTFA considered that percentage higher than expected considering "the industry average of about 60 percent to 75 percent for this type of business in the city it operates and patrons it caters [to]." In addition, CDTFA noted the audited credit-card-sales ratios (rounded) for three similar businesses in the San Gabriel Valley, all of which were lower than 83 percent: (a) 77 percent for a business serving Taiwanese and Japanese cuisine with locations in San Gabriel and the City of Industry; (b) 26 percent for a business serving Chinese cuisine in San Gabriel; and (c) 73 percent for another business serving Chinese cuisine in San Gabriel.

9. Using gross receipts and costs of goods sold reported on appellant's FITRs, CDTFA computed book markups (rounded) of 163 percent for 2016, 163 percent for 2017, and 153 percent for 2018, which averaged 160 percent. CDTFA reduced the reported costs of goods sold for each year of the liability period by $18,000 for the cost of self-consumed food products and by 2 percent each for pilferage and spoilage. CDTFA noted that the resulting book markups were

[5] In a July 20, 2021 memorandum issued during CDTFA's internal appeals process, CDTFA recounted instances when appellant (i.e., one of its corporate officers) denied the existence of its minimum credit card sales policy and the sign. For example, during both the first meeting with appellant at the restaurant, as well as during the exit conference following the audit, CDTFA questioned appellant about the sign, but appellant denied its existence. Because it had photographic proof of the sign's existence, CDTFA concluded that appellant's credibility had been diminished due to "false statements" made to CDTFA.

"substantially" lower than the expected markup range of 200 to 250 percent for this type of business.

10. CDTFA also noted that appellant's book markups were less than the average audited markup of 220 percent for 16 similar restaurants in the cities of San Gabriel and Rosemead, California, that CDTFA had also audited.

11. CDTFA further noted that appellant's book markups for the liability period were "virtually identical" to its book markups of 166 percent and 170 percent that CDTFA had computed for 2011 and 2012, respectively, in the prior audit.

12. Because CDTFA had found a material understatement and computed an audited markup of 253.09 percent using audited sales in that prior audit, CDTFA concluded that appellant's book markups for the liability period were low and constituted evidence that appellant had again understated reported sales.

13. In sum, CDTFA investigated further because appellant's POS system did not record either of the two cash purchases made by CDTFA staff in September 2019, appellant's credit-card sales ratio was higher than expected, and appellant's book markups were lower than expected.

14. In a January 6, 2020 discussion, CDTFA informed appellant that it would be making unannounced purchases, which it would trace to appellant's POS system. CDTFA explained that, if it could verify that the POS records were complete, it would use those records to compute a credit-card-sales ratio. However, if it found that the POS system was not recording some sales, it would conduct on-site observation tests. Subsequently, CDTFA made two cash purchases in January 2020. When it received the POS records on February 21, 2020, CDTFA traced those purchases to the POS records, which recorded one of the two cash purchases.

15. In total, CDTFA staff made five unannounced purchases from the restaurant, two of which were made after CDTFA informed appellant that it would be making such purchases. Of these five purchases, one was paid by credit card and four by cash. The credit-card sale and one of the four cash transactions were recorded by the POS system, while the remaining three cash sales were not recorded.

16. In various discussions with CDTFA over the course of the audit, appellant stated that the POS system sometimes malfunctioned, employees did not really know how to use the

POS system, and there were weak internal controls at the restaurant. Appellant also suggested that the unrecorded sales could represent employee theft.

17. Sometime after CDTFA received appellant's January 2020 POS records on February 21, 2020, CDTFA stopped conducting observation tests due to COVID-19 pandemic restrictions.[6] Appellant also ceased dine-in services and only offered to-go services, as well as delivery through online third-party vendors.

18. To develop audited taxable sales for the liability period, CDTFA decided to employ the credit-card-sales-ratio method. In the prior audit, CDTFA had computed a credit-card-sales ratio of 64.91 percent per observation tests, but did not use that ratio to establish audited sales, either in the prior audit or here. Instead, CDTFA utilized information from the prior audit to formulate a new credit-card-sales ratio, which it then used to establish audited sales for the liability period as follows.

19. CDTFA computed average daily sales for the prior audit period based on observation tests performed on Wednesday, June 26, 2013, and Saturday, July 13, 2013, and then projected the average daily sales to establish audited taxable sales for the prior audit period. CDTFA then used these audited taxable sales from the prior audit period and appellant's credit-card receipts from the prior audit period to establish an audited credit-card sales ratio of 71.42 percent, which CDTFA used in this audit.

20. CDTFA compiled appellant's credit-card receipts for the liability period from appellant's bank statements and reduced them by the amount of sales tax included and by 9.17 percent for tips included.[7]

21. CDTFA divided appellant's credit-card receipts, net of tax and tip, by the credit-card sales ratio of 71.42 percent to compute audited taxable sales of $4,494,231.

[6] With respect to the pandemic, the Governor declared a State of Emergency on March 4, 2020, and issued a stay-at-home order to slow the spread of COVID-19 on March 19, 2020.

[7] CDTFA used appellant's daily merchant batch reports for the week of August 12 through August 18, 2019, to compute the audited estimate of tips included in credit-card payments and the 9.17 percent tip ratio.

22. CDTFA compared audited taxable sales of $4,494,231 to reported taxable sales of $3,880,120 to establish an understatement of reported taxable sales of $614,111, which represented an error rate of 15.83 percent.[8]

23. As a secondary audit method, CDTFA applied the audited markup factor of 353.09 percent[9] from the prior audit period to the costs of goods sold reported on appellant's FITRs for the liability period (after adjustments for the cost of self-consumed food of $18,000 per year and 2 percent each for pilferage and spoilage). Using this procedure, CDTFA computed percentages of understatement of 29.86 percent for 2016, 29.84 percent for 2017, and 35.16 percent for 2018. CDTFA applied those percentages to reported taxable sales for the respective years in the liability period and computed an understatement of $1,247,012, which is more than twice the audited understatement of $614,111.

24. CDTFA used audited taxable sales for 2017 and 2018, along with costs of goods sold (adjusted as explained previously), to compute markups of 203.44 percent for 2017 and 204.87 percent for 2018, for an audited markup percentage of 204.20 percent for the liability period. CDTFA noted that those markups were in line with the industry average and the expected range of 200 to 250 percent.

25. CDTFA recommended a negligence penalty due to inadequate recordkeeping and material underreporting, noting that appellant "has continued to report in the same manner as in the prior audit and has not corrected its reporting" and "has continued to underreport taxable cash sales and suppress its POS system."

26. On December 4, 2020, CDTFA issued the NOD.

27. On December 28, 2020, appellant timely filed a petition for redetermination.

28. On December 9, 2021, CDTFA issued a Decision denying appellant's petition. In its Decision, CDTFA found that, based on appellant's menu, over 80 percent of appellant's gross receipts during the liability period were from the sale of food products and over 80 percent of appellant's retail sales of food products were subject to tax.

29. On January 6, 2022, appellant filed a Request for Reconsideration.

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[8] $614,111 ÷ $3,880,120 = 15.83 percent.

[9] The markup factor is 1 plus the audited markup. When the markup factor is applied to the cost of goods sold, the product of the computation captures both the cost of the merchandise and the markup factor.

30. On May 4, 2022, CDTFA issued a Supplemental Decision, which continued to deny appellant's petition.

31. This timely appeal followed.

DISCUSSION

Issue 1: Whether the determined amount of unreported taxable sales should be reduced.

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sale of all tangible personal property in this state unless a 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, it is presumed that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination on request by CDTFA. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

If CDTFA is not satisfied with the amount of tax or other amount required to be paid by any person, or if any person fails to make a return, CDTFA may compute and determine the amount required to be paid upon the basis of any information within its possession or that 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.) 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 to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

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. (*Appeal of Amaya*, *supra*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) To satisfy the burden of proof, a taxpayer must prove that: (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Appeal of AMG Care Collective*, *supra*.)

Although gross receipts derived from the sale of "food products" for human consumption are generally exempt from the sales tax, those from the sale of food served as meals or for

consumption at a restaurant, or from the sale of hot prepared food, are subject to tax. (R&TC, § 6359(a), (d)(1), (d)(2), and (d)(7).)

When over 80 percent of the seller's gross receipts are from the sale of food products and over 80 percent of the seller's retail sales of food products are subject to tax, then sales of cold food products sold in a form suitable for consumption on the seller's premises is subject to tax even if sold "to go." (R&TC, § 6359(d)(6).) When a retailer's sales fit within this provision, known as the "80/80 rule," the retailer may avoid its application by keeping a separate accounting of its sales to-go of cold food in a form suitable for consumption on the retailer's premises. (R&TC, § 6359(f); Cal. Code Regs., tit. 18, § 1603(c)(1)(A).)

In its Decision, CDTFA found that, based on appellant's menu, appellant's operations met the requirements of the 80/80 rule so that all of appellant's sales of food products during the liability period were subject to tax. Appellant has not disputed this finding.

OTA now turns to whether CDTFA's determination was reasonable and rational. Both before and during this audit, CDTFA made a total of five purchases from appellant's restaurant and found that appellant's POS system did not record three of the five purchases. In discussions with CDTFA during the audit, appellant conceded that its restaurant had weak internal controls, and that employees did not fully understand how to use the POS system, which suggests a significant amount of unrecorded cash sales. OTA concludes that CDTFA reasonably found that appellant had not provided sufficient books and records to verify the accuracy of reported sales using a direct audit approach, and that it was appropriate for CDTFA to utilize the credit-card-sales-ratio method, an indirect audit approach that is a recognized and accepted accounting procedure. (See *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P; *Appeal of Amaya*, *supra*.)

Because COVID-19 pandemic restrictions prevented CDTFA from conducting observation tests to establish the audited credit-card-sales ratio (as CDTFA originally intended), OTA also finds that CDTFA reasonably used information from the prior audit to establish that ratio. As noted earlier, CDTFA did not utilize the credit-card-sales ratio of 64.91 percent, which it computed for the prior audit period from observation tests. Instead, CDTFA used a credit-card-sales ratio of 71.42 percent, which it computed using credit-card receipts and audited taxable sales from the prior audit period (which, in turn, CDTFA computed by projecting average daily sales). Because there is an inverse relationship between the credit-card sales ratio and total sales, CDTFA's use of a credit-card-sales ratio of 71.42 percent rather than

64.91 percent resulted in a lower audited understatement. OTA concludes that CDTFA has shown that its determination is reasonable and rational, so the burden of proof now shifts to appellant to establish that a different result is warranted.

On appeal, appellant generally asserts that CDTFA was partial, unfair, and unjust, and argues that CDTFA did not adhere to required audit procedures but employed an improper audit method instead. Specifically, appellant offers four arguments challenging CDTFA's use of a 71.42 percent credit-card-sales ratio: (1) CDTFA failed to follow its Audit Manual when applying the credit-card sales ratio method; (2) changes in appellant's operations between audits render the 71.42 percent credit-card-sales ratio, which CDTFA established using information from the prior audit period, inapplicable; (3) based on appellant's analysis of its records, appellant's credit-card-sales ratio was higher than 71.42 percent, specifically in the range of 78.00 to 82.00 percent; and (4) CDTFA should have conducted an observation test to formulate the credit-card-sales ratio before the onset of COVID-19 pandemic restrictions.

Appellant also offers seven other arguments aimed at perceived misstatements or mistakes made by CDTFA in its Supplemental Decision: (1) CDTFA incorrectly asserted that it first used the markup audit method to compute the understatement before deciding to use the credit-card-sales ratio method; (2) CDTFA unfairly estimated appellant's unreported taxable sales using a markup percentage from appellant's prior audit; (3) CDTFA overstates audited taxable sales based on the size and seating capacity of appellant's restaurant; (4) CDTFA incorrectly concluded that appellant did not provide complete records; (5) the number of cash sales missing from appellant's POS records was minimal; (6) CDTFA wrongly concluded that appellant's markups were lower than expected—rather, they were lower because of increased costs; and (7) CDTFA inappropriately used estimates rather than actual audit procedures to compute audited taxable sales.

OTA will analyze each set of arguments in turn.

Four Arguments Challenging CDTFA's Use of a 71.42 Percent Credit-Card-Sales Ratio

First, appellant argues that it was inappropriate for CDTFA to use the credit-card sales ratio from the prior audit period,[10] which appellant equates to the use of a prior audit percentage of error (PAPE). Appellant contends that CDTFA's Audit Manual section 0405.33 applies to

[10] Appellant uses the term "electronic payment ratio;" OTA uses "credit-card-sales ratio" because this audit method is typically referred to as the credit-card projection of sales method.

either figure, but CDTFA did not follow proper audit procedures when it used the credit-card-sales ratio from the prior audit period in this audit.

The title page to Chapter 1 (*General Information*) of CDTFA's Audit Manual states that it "is an advisory publication providing direction to [CDTFA] staff administering the Sales and Use Tax Law and Regulations." CDTFA's Audit Manual has not been adopted pursuant to a formal rulemaking process, so OTA cannot enforce, attempt to enforce, or even utilize CDTFA's Audit Manual as a manual, guideline, or standard of general application. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P, at p. *15, fn. 20, citing Gov. Code, § 11340.5.) Furthermore, contrary to appellant's assertion, a credit-card-sales ratio and a PAPE are not the same. The PAPE was 31.56 percent, the percentage of error for the audit at issue is 15.83 percent, and CDTFA did not use the former to compute the audited understatement for this audit. For these reasons, the provisions in CDTFA's Audit Manual for using a PAPE are neither applicable nor relevant here.

Second, appellant argues that CDTFA was required to conduct limited testing to determine whether there were changes to appellant's operations since the last audit and to analyze other changes in key personnel. These requirements, quoted from Audit Manual section 0405.33, relate solely to CDTFA's use of the PAPE. Again, OTA may not utilize CDTFA's Audit Manual as a manual, guideline, or standard of general application. (*Appeal of Micelle Laboratories, Inc.*, *supra*.) Thus, the alleged requirements are irrelevant to CDTFA's use of a credit-card sales ratio.

However, it is true that it would be inappropriate to use information from the prior audit if the information *significantly* changed. For instance, in this case, there would be concern if appellant provided evidence of a significant increase in its customers' credit-card usage. Appellant attempted to provide such evidence by arguing that it never had a policy of accepting credit cards only for purchases of $25 or more and denied the existence of a sign notifying customers of such a policy. To that end, when CDTFA met with appellant at the restaurant during the audit, appellant had removed its sign stating that policy. However, CDTFA had photographic evidence that the sign had been in place during the liability period. Thus, appellant prevaricated.[11]

[11] See footnote 5, *ante*, page 3.

Nevertheless, the evidence does show that appellant's costs of goods sold increased from $236,243 in 2011 and $318,780 in 2012 to $428,328 in 2017 and $483,987 in 2018. Appellant has also provided figures indicating that its number of sales increased during the liability period.

The sales figures provided by appellant have not been verified, but the number of appellant's sales have likely increased during the liability period since the reported costs of goods sold have also increased. However, the relationship between the costs of goods sold and the sales reported by appellant remained almost the same. Specifically, the book markups of 166 percent and 170 percent for 2011 and 2012, respectively, are similar to the book markups of 163 percent and 153 percent for 2017 and 2018, respectively. The similarity of the book markups is evidence that appellant's recording and reporting procedures remained relatively constant from the prior audit period to the current liability period. This undercuts the main point of appellant's argument that there were material changes in appellant's operation. Further, there is no evidence that the increases in costs and sales also represented an increase in customers' use of credit cards. The main issue is whether there was a higher percentage of sales made by credit card in the liability period, which appellant's third argument addresses.

Third, appellant contends that it analyzed its recorded sales for Wednesdays and Saturdays in the months of June and July for 2017, 2018, and 2019, which revealed a credit-card-sales ratio of 78 percent for Wednesdays and 82 percent for Saturdays, rather than the audited credit-card sales ratio of 71.42 percent that CDTFA computed and used during the audit. Appellant observes that CDTFA used the same type of test to compute the credit-card-sales ratio of 64.91 percent for the prior audit period, so those higher credit-card-sales ratios should also be used here. Appellant implies that the higher credit-card-sales ratio would translate into lower total sales and lower unreported taxable sales.

However, appellant's analysis is based on recorded figures, with estimates for missing cash sales, and OTA has already concluded that, because of a pattern of unrecorded cash sales, appellant's records were incomplete and thus inadequate for purposes of performing a direct audit. Although appellant made estimates for some missing cash sales, there is insufficient information in the record for OTA to evaluate whether appellant's estimates are reasonable. And although CDTFA did use the same type of test in the prior audit, it did not use the resultant credit-card-sales ratio to compute audited sales; rather, CDTFA projected average daily sales to establish audited taxable sales in the prior audit.

In this audit, CDTFA used credit-card receipts and audited taxable sales from the prior audit to compute the credit-card-sales ratio of 71.42 percent applied in this audit. CDTFA computed credit-card receipts and audited taxable sales based on average daily sales, which CDTFA actually observed. Thus, there are no estimates of numbers of sales or sales amounts as in the computations suggested by appellant. OTA concludes that appellant has not satisfied its burden of proving that its actual credit-card-sales ratios for the liability period were in the range of 78 to 82 percent.

Fourth, appellant asserts that, instead of using information from the prior audit to formulate the 71.42 percent credit-card-sales ratio applied in the audit at issue, CDTFA could have conducted an observation test to do so before the state instituted restrictions related to COVID-19.

Here, CDTFA had intended to utilize appellant's records to establish the credit-card-sales ratio. However, when CDTFA received the POS records on February 21, 2020, CDTFA found that the records did not record one of its two cash purchases made during January 2020. Because appellant's failure to record all cash sales had continued through January 2020, CDTFA concluded that the records for January 2020 were not reliable. CDTFA did not reach this conclusion until late February 2020, and the restrictions related to COVID-19 were instituted shortly thereafter.[12] Accordingly, CDTFA did not have the opportunity to conduct observation tests to establish the audited credit-card sales ratio.

To summarize, OTA finds that appellant's four arguments challenging CDTFA's use of a 71.42 percent credit-card-sales ratio lack merit, and concludes that no adjustment is warranted to that audited ratio. OTA now turns to appellant's other arguments on appeal.

Seven Other Arguments Against CDTFA's Audit

First, in its opening brief, appellant disputes an assertion, made in CDTFA's Supplemental Decision, that CDTFA first computed the understatement using the markup audit method and then decided to use the credit-card-sales ratio method, which resulted in a lower understatement. Appellant argues that this assertion was incorrect and states that CDTFA first computed the understatement using the credit-card sales ratio method.

[12] See footnote 6, *ante*, page 5.

Appellant may be correct, but the order in which CDTFA utilized the two audit methods is less important than how CDTFA used their results. Notably, the understatement calculated by the markup method (i.e., the "first" method), using the audited markup from the prior audit period, would have been over twice as high as the understatement established using the credit-card-sales-ratio method (i.e., the "second" method). Instead, CDTFA's determination primarily relied upon the credit-card-sales-ratio method, which yielded a comparatively lower liability for appellant. OTA concludes that the order in which CDTFA made the computations is not relevant.

Second, appellant contends that "it is unfair to estimate the unreported taxable sales for the current [liability] period using prior audit percentage of errors of the markup of cost method in the prior audit period."

To clarify, CDTFA did not apply the markup from the prior audit period in its computation of audited taxable sales; rather, it utilized the markup method only to verify that the audit results, which were computed using the credit-card-sales ratio method, were reasonable. OTA finds that this argument also lacks merit.

Third, appellant offers various estimates of the sales its restaurant could have made, based on the size of the restaurant, arguing that the audited taxable sales of $4,494,231 could not be reasonable for a restaurant of its size. Appellant asserts a maximum seating capacity of 56 people for its restaurant and asserts that the restaurant could only take 57 orders on weekdays, inclusive of to-go orders, during the liability period.[13]

However, appellant's assertion presumes that there is only one sale for each seat in the restaurant each day, which does not appear logical. Generally, OTA would expect dynamic turnover of tables/seats with diners regularly going in and out of a restaurant during business hours; assuming a limit of 57 sales per weekday for a restaurant with 56 seats does not appear reasonable. Further, appellant mentions that it made sales of food to-go. Therefore, the number of seats in appellant's restaurant does not limit the number of sales the restaurant could make. In addition, appellant estimates a maximum number of five missing sales per day. Appellant has not supported that figure, so OTA accords it no evidentiary value. Accordingly, appellant has

[13] CDTFA asserts appellant's restaurant had a maximum capacity of 95 people. OTA makes no attempt to determine which number is correct.

not shown that the audit results are unreasonable for a restaurant with the size and capacity of appellant's restaurant.

Fourth, appellant disputes a comment by CDTFA in its Supplemental Decision that appellant did not make complete records available. Appellant asserts that it offered three boxes of daily sales receipts and other supporting documents to CDTFA's auditor, but the auditor said it was not necessary.

Based on the record, OTA does not know whether appellant actually offered CDTFA those documents. But even if it had, appellant has not submitted them here in this appeal before OTA or explained how they prove that: (1) the tax liability is incorrect, and (2) the proper amount of the tax. Thus, it is immaterial whether appellant offered three boxes of sales receipts to CDTFA during the audit.

Fifth, on the issue of missing cash sales, appellant argues that these were minimal, noting that CDTFA only identified three unrecorded sales.

This argument misses the larger picture. Over four days, CDTFA made five purchases (one by credit card and four by cash), which it traced to appellant's POS records. Of those five purchases, three were not recorded. More significantly, of the four *cash* purchases, three were not recorded.[14] Accordingly, appellant did not record 60 percent of purchases tested or 75 percent of *cash* purchases tested. That level of unrecorded sales is substantial, not minimal.

Furthermore, appellant was aware that there were unrecorded sales. During discussions with appellant (i.e., one of its corporate officers) during the audit, appellant stated that employees did not understand the POS system and asserted that the POS system sometimes malfunctioned. The corporate officer also stated that he was often not in the restaurant and employees had full access to the cash register, implying that employees may have stolen cash. Thus, contrary to appellant's argument on appeal, the problem of unrecorded cash sales was an ongoing, significant issue for appellant.

Sixth, to dispute CDTFA's comments in the Supplemental Decision that the book markup was lower than expected, appellant argues that the markup was lower in the liability period than it was in the prior audit period. As support, appellant provides a table showing increases in food costs.

[14] Accurately recording a credit card sale is not particularly relevant in analyzing the accuracy of a taxpayer's records. A credit-card sale must be recorded, and the credit-card information must be presented to the bank because, otherwise, the retailer will not receive the funds for the sale.

Appellant has not supported the figures in that table with any evidence. Regardless, OTA notes that the audited markup for the liability period is 204.20 percent, while the audited markup for the prior audit period was 253.09 percent. Thus, the audited figures do show a lower markup for the liability period. The decrease in the audited markup likely addresses the increases in food costs that appellant asserts but has not documented. Accordingly, OTA concludes that no adjustments are warranted based on appellant's assertion that its markup was even lower in the liability period than the markup reflected by audited taxable sales.

Seventh, appellant asserts that the audited sales computed using the credit-card-sales ratio method and the markup method are estimates, rather than data developed using "actual audit procedures."

There were indeed estimates in CDTFA's computations. However, both the credit-card-sales-ratio method and the markup audit are recognized and accepted accounting procedures. (*Appeal of Amaya*, *supra*.) Further, CDTFA is authorized to verify the accuracy of any return made or, if no return is made, to ascertain and determine the amount required to be paid. (R&TC, § 7054.) In so doing, CDTFA may compute and determine the amount required to be paid upon the basis of any information within its possession or that may come into its possession. (R&TC, § 6481.) Accordingly, OTA finds that CDTFA has used appropriate audit methods to establish the understatement.

In summary, based on the above analysis of CDTFA's audit and appellant's arguments on appeal, OTA concludes that appellant has not met its burden to show that adjustments are warranted to the audited understatement of reported taxable sales. Accordingly, OTA concludes that the determined amount of unreported taxable sales should not be reduced.

Issue 2: Whether appellant was negligent or intentionally disregarded relevant authorities.

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 Sales and Use Tax Law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto.

Taxpayers are required to maintain and make available for examination on request by CDTFA 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 sales and use tax returns. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited

to: (a) normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (b) bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and (c) schedules or working papers used in connection with the preparation of 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 or intent to evade the tax and may result in penalties. (Cal. Code Regs., tit. 18, § 1698(k).) Additionally, if a taxpayer has been notified of reporting errors committed during an audit period, and continues to commit the same reporting errors during a subsequent audit period, then that is evidence of negligence. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-323.)

CDTFA applied the negligence penalty because it found that appellant had failed to accurately record and report its taxable sales. Specifically, CDTFA noted that appellant continued to report in the same manner as in the previous audit and to underreport taxable cash sales. CDTFA noted that appellant was aware that cash sales were sometimes not recorded and had estimated that five cash sales were not recorded each day. However, appellant did not take adequate steps to correct that significant inaccuracy in its records.

Here, the understatement in the liability period represented 15.83 percent of reported taxable sales. Appellant did not record all of its cash sales, and it was aware of that deficiency in its records but offered no explanation of efforts to correct it. The level of understatement and the failure to correct a significant problem with record-keeping are both evidence of negligence. Moreover, the errors found by CDTFA during the liability period resembled the errors found in the prior audit. Appellant's failure to address deficiencies in its record-keeping and reporting is further evidence of negligence.

For these reasons, OTA finds that the negligence penalty was properly applied.

HOLDINGS

1. The determined amount of unreported taxable sales should not be reduced.
2. Appellant was negligent.

DISPOSITION

Sustain CDTFA's Decision, as amended by its Supplemental Decision, denying appellant's petition for redetermination.

DocuSigned by:
8A4294817A67463...
Andrew Wong
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
CB1E7DA37831416...
Josh Lambert
Administrative Law Judge

DocuSigned by:
Ovsep Akopchikyan
88E35E2A835348D...
Ovsep Akopchikyan
Administrative Law Judge

Date Issued: 5/26/2023