OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 220410267
	CDTFA Case ID 2-096-282
AS SWIPE, INC.,	
dba Lucky 13	

OPINION

Representing the Parties:

For Appellant:	Brian Spiers, President Laura Weiss, Representative
For Respondent:	Randolph (Randy) Suazo, Hearing Representative Jason Parker, Chief of Headquarters Ops. Christopher Brooks, Attorney
For Office of Tax Appeals:	Craig Okihara, Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, As Swipe, Inc. (appellant) appeals a Decision, as amended by a Supplemental Decision, issued by the California Department of Tax and Fee Administration (respondent)[1] denying, in part, appellant's petition for redetermination of the Notice of Determination (NOD) dated March 5, 2020.[2] The NOD is for a tax of $84,408.00, applicable interest, and a negligence penalty of $8,440.76 for the period January 1, 2015, through December 31, 2017 (liability period).

As explained below, respondent concedes to reducing the determined measure of tax from $971,742 to $468,062, which will result in reductions to the tax. Respondent also deleted the negligence penalty.

[1] Sales taxes were formerly administered by the Board of Equalization (board). Effective July 1, 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

[2] The NOD was timely issued because on August 23, 2019, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period January 1, 2015, through December 31, 2016, which allowed respondent until April 30, 2020, to issue an NOD. (R&TC, §§ 6487(a), 6488.)

Office of Tax Appeals (OTA) Administrative Law Judges Josh Aldrich, Teresa A. Stanley, and Keith T. Long held an electronic oral hearing for this matter on June 16, 2023. At the conclusion of the hearing, the record was closed, and this matter was submitted for an Opinion.

ISSUES

1. Whether further adjustments to the amount of unreported taxable sales are warranted.
2. Whether interest relief is warranted.

FACTUAL FINDINGS

1. Appellant, a corporation dba Lucky 13, operated a bar selling liquor, wine, and beer, in San Francisco, California. Appellant's advertised selling prices included sales tax reimbursement. Appellant only accepted cash as payment. Appellant's seller's permit was opened with an effective start date of November 1, 2000.
2. Appellant was previously audited for the period April 1, 2011, through March 31, 2014. The prior audit calculated markups of 154.91 percent for beer; 277.79 percent for liquor; 313.23 percent for wine; and 241.32 percent for bottled beer. The weighted average markup for alcoholic beverages was 213.98 percent. The prior audit also established pour sizes as follows: 4.83 ounce pour for wine; 2.18-ounce weighted pour size for liquor; and 16.00 ounces for draft beer. The pour test during the prior audit established a pour size of 3.33 ounces for a martini.
3. For the prior audit, respondent issued its Report of Field Audit and Report of Discussion Audit Findings on December 22, 2015, and February 26, 2016, respectively. On March 14, 2016, respondent issued its determination.
4. For the liability period, appellant reported on its sales and use tax returns (SUTRs) total sales of $2,299,258, claiming no deductions. Appellant stated that total sales were reported based on bank deposits.
5. On March 2, 2018, respondent issued an audit engagement letter to appellant. Between March 2018 and September 2019, respondent was actively working on the audit (e.g., obtaining a waiver from appellant, reviewing appellant's submissions, as well as preparing and revising the audit work papers) as discussed below.

6. For audit, appellant provided federal income tax returns (FITRs) for 2015 and 2016; profit and loss statements and general ledger for the liability period; bank statements for the liability period; merchandise purchase invoices for the period January 1, 2015, through December 31, 2017, and the period April 1, 2018, through June 30, 2018; and various sales tax worksheets. Appellant used two cash registers to ring-up sales but did not maintain or provide cash register tapes for the liability period.[3]
7. Respondent compared gross receipts reported on the FITRs to the corresponding taxable sales reported on the SUTRs for 2015 and 2016 noting minor differences.
8. Respondent compared total sales recorded in the profit and loss statements to the corresponding total sales reported on the SUTRs for the liability period noting minor differences.
9. Respondent compared taxable sales reported on the SUTRs to the corresponding alcohol purchases (as explained below) and computed SUTR book markups of 87.95 percent for 2015, 108.81 percent for 2016, 124.73 percent for 2017, and 106.63 percent for the three years combined.[4] Respondent expected a markup between 180 percent to 300 percent based on bar industry averages. Based on the industry averages, and because the markup was significantly lower than the markup established in the prior audit, respondent considered the SUTR book markups to be low. Respondent concluded that additional testing was required to verify reported taxable sales because appellant did not provide source documentation (e.g., cash register z-tapes) and because the markups were low and inconsistent.

[3] The cash register z-tape is the portion of the cash register tape that summaries sales for a period of time.

[4] "Markup" is the amount by which the cost of merchandise is increased to set the retail price. For example, if the retailer's cost is $0.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (0.30 ÷ 0.70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records. Markup and gross profit margin are different. The gross profit is the sales price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sales price. In the above example, the gross profit margin is 30 percent (0.30 ÷ 1.00 = 0.30).

10. Respondent compiled bank deposits[5] from sales proceeds, excluding sales tax reimbursement, of $2,157,329 for the liability period. Upon comparison to taxable sales reported on the SUTRs, respondent found reported taxable sales exceeded bank deposits from sales proceeds by $141,929. Respondent decided not to use the bank-deposit-analysis method to verify reported sales because appellant did not deposit all cash sales.
11. Respondent decided to use the markup method to compute taxable sales.
12. From the general ledgers, respondent compiled recorded alcohol purchases (liquor, wine, and beer) of $1,112,754, mixers and supplies of $78,054, and miscellaneous purchases of $2,679 for the liability period. Based on its discussions with appellant, respondent excluded self-consumption[6] of $90,804 ($7,567 per quarter allowed in the prior audit × 12 quarters), and pilferage of $20,439 (2 percent) from recorded alcohol purchases to calculate the audited cost of alcohol of $1,001,511 for the liability period.
13. Using liquor, wine, and beer purchase invoices for April 2018 and May 2018, and selling prices obtained from appellants on the Bar Fact Sheet, Form CDTFA-1311-B,[7] dated July 26, 2018, respondent performed a shelf test[8] and computed shelf test markups as discussed below.
14. For liquor, based on discussions with appellant and information that appellant provided on the Bar Fact Sheet, respondent computed an average liquor pour size of 2.87 ounces. Respondent computed a markup of 201.00 percent for regular pricing, and 486.36 percent for happy hour pricing.[9] Respondent applied a 60 percent regular prices ratio and a

[5] Bank deposits are not gross receipts. (R&TC, § 6012(a).) However, where, as here, a retailer is engaged in the business of making retail sales of tangible personal property, the retailer's bank deposits, net of deposits from non-sale or nontaxable transactions, are evidence of gross receipts from the retail sale of tangible personal property, which respondent can use to determine audited taxable sales when sales cannot be accurately established using a direct approach.

[6] Respondent established a separate measure of tax for the cost of self-consumed taxable merchandise. Self-consumed merchandise is subject to tax on the cost of the merchandise rather than the sale price. Appellant does not dispute this audit item; thus, OTA does not discuss it further.

[7] A Bar Fact Sheet is a form completed with input from a taxpayer that provides various information regarding the operation of a bar, such as selling prices, pour sizes, glass sizes, pilferage, and self-consumption.

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

[9] The markup for regular pricing and happy hour pricing was revised in the reaudit.

40 percent happy hour prices ratio to the respective liquor shelf test markups and computed a combined regular and happy hour liquor markup of 315.14 percent.[10]

15. For wine, respondent computed a markup of 136.73 percent. Appellant did not have happy hour pricing on wine.

16. For bottled beer, respondent computed a markup of 199.07 percent. Appellant did not have happy hour pricing on bottled beer. For draft beer, respondent computed a markup of 160.50 percent for regular pricing, and 113.15 percent for happy hour pricing. Respondent applied the 60 percent regular prices ratio and the 40 percent happy hour prices ratio to the respective draft beer shelf test markups and computed a combined regular and happy hour draft beer markup of 132.09 percent.

17. Respondent performed a purchase segregation test[11] using available merchandise purchase invoices for 3Q16, which disclosed that liquor purchases accounted for 41.27 percent, wine purchases accounted for 3.06 percent, bottled beer purchases accounted for 14.57 percent, and draft beer accounted for 41.10 percent of alcohol purchases. Respondent applied the liquor, wine, and bottled and draft beer purchase percentages from the segregation test to the respective shelf-test markups to compute a weighted average markup of 217.54 percent. Respondent noted that the audited weighted average markup exceeded the SUTR book markup by more than the 10 percent tolerance used to evaluate bar audit findings.[12]

18. Respondent added the audited weighted markup of 217.54 percent to the audited cost of alcohol and computed audited taxable sales of $3,180,197 for the liability period. Upon comparison to reported taxable sales, respondent computed unreported taxable sales of $880,939 for the liability period.

19. On October 2, 2019, respondent completed its audit workpapers. On October 4, 2019, respondent issued a letter to appellant with respondent's audit results and findings.

[10] On the Bar Fact Sheet, appellant stated that 40 percent of its sales were at regular prices and 60 percent were at happy hour prices. Respondent corrected the error in the reaudit. (See Factual Finding 25.)

[11] A purchase segregation test is used to establish the proportion of merchandise purchases in various product categories (such as beer, wine, liquor, soda, "other" taxable merchandise, food, and mixes and supplies) in order to compute the percentage of taxable merchandise purchases, as well as the percentages of merchandise in each category.

[12] See CDTFA Audit Manual section 0802.65.

Appellant disagreed with respondent. Respondent and appellant discussed the audit on November 26, 2019. On February 28, 2020, respondent issued a Report of Discussion of Audit Findings.

20. On March 5, 2020, respondent issued the NOD, for the liability disclosed by the audit, with a tax liability of $84,408.00, plus applicable interest, and a negligence penalty of $8,440.76.

21. On March 21, 2020, appellant filed a timely petition for redetermination disputing the NOD in its entirety.

22. Respondent issued a Decision dated June 25, 2021, which ordered a reaudit as follows: increase the pour size for martinis to 3.33 ounces as computed in the prior audit and recompute a weighted-average pour allowance; allow appellant the opportunity to provide documentation to support its ratio of well, call, and premium liquor purchases in the purchase segregation test; make adjustments to the markups if support documentation is provided; delete the negligence penalty; and otherwise deny the petition.

23. Respondent performed a reaudit dated August 5, 2021, which decreased the total measure of tax by $503,680 from $971,742[13] to $468,062.[14] Respondent also deleted the negligence penalty. The reaudit established the measure of tax as discussed below.

24. Appellant prepared a revised purchase segregation test for 3Q16, in which it identified well liquors separately from call and premium liquors, and several misclassified items. Appellant computed ratios for well liquor purchases of 3.81 percent, call and premium liquor purchases of 35.62 percent, wine purchases of 4.39 percent, bottled beer purchases of 15.41 percent, and draft beer of 40.77 percent of alcohol purchases. Respondent spot-checked appellant's changes noting no errors.

25. For liquor, respondent increased the pour size for martinis to 3.33 ounces and computed an average liquor pour size of 2.89 ounces. Respondent computed a well liquor markup of 641.11 percent for regular pricing, and 525.79 percent for happy hour pricing. Respondent applied the 40 percent regular prices ratio and the 60 percent happy hour prices ratio to the respective well liquor shelf test markups and computed a combined regular and happy hour liquor markup of 571.92 percent. Respondent computed a call

[13] $90,804 unreported cost of taxable merchandise self-consumed + $880,938 unreported taxable sales.

[14] $90,804 unreported cost of taxable merchandise self-consumed + $377,258 unreported taxable sales.

and premium liquor markup of 155.70 percent for regular pricing, and 155.08 percent for happy hour pricing. Respondent applied the 40 percent regular prices ratio and the 60 percent happy hour prices ratio to the respective call and premium liquor shelf test markups and computed a combined regular and happy hour liquor markup of 155.33 percent.

26. For bottled beer, respondent excluded two misclassified liquor items and computed a markup of 196.53 percent.

27. Respondent applied the well liquor, call and premium liquor, wine, and bottled and draft beer purchase percentages from the revised segregation test to the respective shelf-test markups to compute an audited weighted markup of 167.25 percent.

28. Respondent applied the audited weighted markup of 167.25 percent to the audited cost of alcohol of $1,001,511 and computed audited taxable sales of $2,676,516 for the liability period. Upon comparison to reported taxable sales, respondent computed unreported taxable sales of $377,258 for the liability period.

29. By memorandum dated August 20, 2021, respondent's audit staff stated it completed the reaudit adjustments in accordance with the Decision. By email, dated September 7, 2021, appellant filed a request for reconsideration with CDTFA.

30. Respondent issued a Supplemental Decision dated March 22, 2022, ordering that the liability be redetermined in accordance with the reaudit dated August 5, 2021, and otherwise denying the petition for redetermination.

31. On April 25, 2022, appellant timely appealed to OTA.

DISCUSSION

Issue: Whether further adjustments to the amount of unreported taxable sales are warranted.

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, the law presumes 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. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

If respondent is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, 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, 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*.) 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*, 2020-OTA-173P.) The burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) 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*, *supra*.)

Here, appellant did not maintain cash register tapes or other source documentation to support its sales for the liability period. Accordingly, appellant's books and records provided for audit were inadequate for sales and use tax audit purposes. As such, respondent was unable to verify sales that appellant reported on its SUTRs for the liability period using a direct audit method (i.e., compiling audited sales directly from appellant's records). During its initial examination, respondent found lower than expected book markups when respondent compared computed markups to industry standards and the computed markups to those in the prior audit. Also, the book markups varied between 87.95 percent and 124.73 percent. Respondent considered this information to be an indication that reported sales may have been understated. Respondent then utilized an indirect method, specifically the markup method, as the basis for its determination. The markup method is a recognized and standard accounting procedure. (See *Appeal of Amaya, supra*.) Based on the foregoing, OTA finds that respondent met its initial burden to show that its determination was reasonable and rational. Thus, the burden of proof shifts to appellant.

Appellant describes the bar as a local "dive bar" that was known for fast, cheap, and strong drinks, free BBQs every Saturday, free popcorn, pool tables, picnic tables on the patio, and an abundance of dogs. Appellant contends that the audit does not reflect actual pour amount and prices charged during the liability period. Appellant also asserts that the audit relies on information from the prior audit which was not accurate.

Regarding the pricing contention, appellant argues that respondent should have used the 2016 selling prices and cost of goods sold to compute the markup up instead of the 2018 selling prices and cost of goods sold. In support, appellant offers a handwritten price list from March 15, 2016. Appellant contends that the matching principle, a standard principle in accounting, would be more closely represented if respondent were to use the selling prices and cost of goods sold during the audit period, not after.

Regarding the reliance on the prior audit, appellant points out that appellant did not appeal the prior audit, but instead settled it because appellant was overwhelmed by the process. Further, in the current audit appellant was able to show a significant reduction to the taxable measure was warranted. Appellant attributes this reduction to showing error in respondent's auditing protocols. Therefore, it is appellant's position that reliance on any portion of the prior audit is erroneous.

Also, appellant asserts that the pour test that was established in the prior audit and used, in part, in the present audit is erroneous. In support of this proposition, appellant notes that the 2.18 ounce pour test established in the prior audit is only slightly higher than a standard pour, which is inconsistent with the reputation of the bar and evidence. Instead, appellant asserts that its martinis had a pour size of 6.03 ounces based on the size of the glass (i.e., 8 ounces) and the pour test that the auditor observed. Appellant also contends that the pour size of lower priced drinks are 2.10 ounces per serving, which is 0.71 ounces smaller than the 2.89 ounce pour size used in the reaudit, and that by lowering the prices of those drinks the markup would also decrease.

Here, appellant operated as a cash only business and did not maintain or provide cash register tapes. Since the business was cash only, respondent could not utilize the credit-card-sales ratio method to establish audited sales or as a reasonableness test.[15] As noted above,

[15] The credit-card-sales ratio method is another indirect method that is recognized and standard accounting procedure. (*Appeal of Amaya*, *supra*.)

respondent may use any information in its possession or that may come into its possession to determine the correct amount of tax. (R&TC §§ 6481, 6511.)

With respect to the pricing contention, respondent utilized a shelf test. To compute the markup, respondent examined known costs and known prices. OTA notes that respondent initially completed a purchase segregation test using purchase invoices for 3Q16. Respondent then utilized purchase invoices for two months, April and May 2018. For a bar, a period of two months is generally sufficient to encompass a full purchasing cycle, and appellant has not introduced evidence that the two-month period tested for this audit was insufficient. (See CDTFA Audit Manual sections 0807.10, 0807.15 for the discussion on purchasing cycles.) To establish selling prices, respondent requested information for the Bar Fact Sheet, which was completed by the managing bartender and the auditor on July 26, 2018, or shortly after the purchase cycle. While the purchasing cycle occurred shortly after the end of the audit period, the prices established in the Bar Fact Sheet are entitled to more weight than the unverified handwritten note from March 15, 2016. Respondent used the Bar Fact Sheet prices and purchase invoices from April and May 2018 to calculate the markup. Therefore, OTA finds appellant's matching principle argument to be without merit.

In the reaudit, respondent made several adjustments in appellant's favor to account for heavy pours and lower markups, as contended by appellant. Respondent also incorporated allowances for self-consumption and pilferage. To the limited extent that the pour sizes from the Bar Fact Sheet of the prior audit were utilized in the present audit, the pour sizes were largely in appellant's favor. Regarding martini pour sizes, respondent considered the pour size of martinis, as established on the Bar Fact Sheet, to be unreasonable; and thus rejected the pour size of the martini. OTA agrees that the 6.03 ounce pour size should be rejected as unreasonable without more substantiation. Here, OTA emphasizes that the pour test is designed to examine the taxable liquor in an alcoholic beverage. Just because 6.03 ounces of liquid was measured coming out of the martini glass does not mean the entirety of that liquid was taxable liquor. Further, the 8-ounce martini glass was also used for drinks like Manhattans, Cosmopolitans, and Margaritas.[16] While the 8-ounce martini glass in question could physically accommodate 6.03 ounces of

[16] Regarding the disputed pour sizes, OTA notes that according to the June 25, 2021 Decision, respondent encouraged its auditor to conduct an undercover pour test. Generally, when CDTFA conducts an undercover pour test CDTFA will purchase alcoholic drinks and have those drinks analyzed. (See CDTFA Audit Manual sections 0806.00, 0806.40.) However, the bar ceased operating before an undercover pour test could be completed. Accordingly, this evidence is unavailable to OTA.

liquor, OTA does not find this evidence compelling because there are varying kinds of martinis or cocktails that utilize adjuncts such as water (often from melted ice), juice, coffee, simple syrup, or others non-alcoholic liquids.

Based on the limited records and appellant's business practices, OTA finds that the markup method as utilized in the reaudit provided the most reliable evidence of appellant's unreported taxable sales. Appellant has not identified any errors in respondent's computation of audited taxable sales or provided new documentation or other evidence in support of its contentions from which a more accurate determination could be made. As appellant bears the burden of proof in this case, OTA must conclude that no adjustments are warranted.

Issue 2: Whether interest relief is warranted.

The imposition of interest is mandatory. (R&TC, § 6482.) There is no statutory right to interest relief. (R&TC, § 6593.5.) The law allows CDTFA, in its discretion, to grant relief of all or any part of interest imposed on a person under the Sales and Use Tax Law where the failure to pay the tax is due in whole or in part to an unreasonable error or delay by an employee of CDTFA acting in his or her official capacity. (R&TC, § 6593.5(a)(1).) An unreasonable error or delay shall be deemed to have occurred only if no significant aspect of the error or delay is attributable to an act of, or failure to act by, the taxpayer. (R&TC, 6593.5(b).) Any person requesting interest relief must include a statement under penalty of perjury setting forth the facts on which the request is based. (R&TC, § 6593.5(c).) When CDTFA denies a request for relief of interest, OTA will review that decision for abuse of discretion. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P; see *Appeal of Gorin*, 2020-OTA-018P.)

Appellant requests interest relief from 2015 through the present. Respondent has rejected appellant's request for interest relief because it claims there were no periods of unreasonable delay attributable to respondent.

The timeframe for the requested interest relief is essentially three separate periods: the period prior to the March 2, 2018 audit engagement letter, the period from March 2, 2018, through April 21, 2022, and the period from April 21, 2022, through the present. Regarding the first period, OTA does not find any unreasonable error or delay attributable to respondent because respondent had not yet contacted appellant. Further, when respondent did contact appellant, it was within the statute of limitations to issue a determination. (R&TC, §§ 6487(a), 6488.) With respect to the second period, the evidence shows that respondent was actively

working on the appeal from the March 2, 2018 audit engagement letter through the issuance of the Supplemental Decision dated March 22, 2022. Although, as appellant points out, there was a significant decrease in the measure between the initial audit report and the reaudit, OTA does not find an error or delay attributable to respondent. Instead, much of the adjustments or allowances were attributable to appellant's lack of records. For the final period, there is no statutory authority to grant interest relief while the appeal is before OTA.[17] In summary, appellant has not shown that CDTFA abused its discretion in denying interest relief.

HOLDINGS

1. Appellant has not shown that further adjustments to the measure of tax are warranted.
2. Appellant has not established that interest relief is warranted.

DISPOSITION

Respondent's action in reducing the determined measure of tax by $503,680 from $971,742 to $468,062 and deleting the negligence penalty but otherwise denying the petition is sustained.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
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Teresa A. Stanley
Administrative Law Judge

DocuSigned by:
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Keith T. Long
Administrative Law Judge

Date Issued: 9/22/2023

[17] R&TC section 6593.5 was amended, effective January 1, 2023, to specifically limit the scope of interest relief to errors or delays by "the Department" (i.e., CDTFA). Also, there is no statute which allows OTA to independently grant interest relief for errors or delays by OTA.