

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:)
DUDLEY RESTAURANTS, INC.) OTA Case No. 21067998
) CDTFA Case ID 103-047
)
)
)
)

OPINION

Representing the Parties:

For Appellant: Rex W. Halverson

For Respondent: Ravinder Sharma, Hearing Representative
Stephen Smith, Attorney
Jason Parker,
Chief of Headquarters Operations

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

N. RALSTON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Dudley Restaurants, Inc. (appellant) appeals a decision issued by the California Department of Tax and Fee Administration (respondent)¹ partially denying appellant’s petition for redetermination of the Notice of Determination (NOD) dated June 2, 2017.² The NOD is for a tax of \$58,920.20, plus applicable interest, for the period April 1, 2012, through March 31, 2015 (audit period). In its subsequent decision, respondent reduced the audited understatement of tax to \$41,706.

¹ Sales and use taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of BOE relevant to this case were transferred to respondent. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, “respondent” shall refer to BOE.

² The NOD was timely issued because appellant signed a series of waivers of the otherwise applicable statute of limitations, which extended the period for issuing an NOD until July 31, 2017. (R&TC, §§ 6487(a), 6488.)

Office of Tax Appeals (OTA) Administrative Law Judges Andrew Kwee,³ Josh Lambert, and Natasha Ralston held an oral hearing for this matter via Webex on October 17, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

ISSUE

Whether appellant has established that further adjustment is warranted to the audited understatement of reported taxable sales.

FACTUAL FINDINGS

1. Appellant operated a restaurant since November 2004, serving French-style cuisine and offering alcoholic beverages.
2. For the audit period, appellant reported total sales of \$3,000,882; claimed nontaxable sales of food products of \$4,767 (in the second and third quarters of 2014 only); and reported taxable sales of \$2,996,115.
3. For audit, appellant provided federal income tax returns (FITRs) for 2012, 2013 and 2014; profit and loss statements (P&Ls) for the period January 1, 2012, through March 31, 2015; monthly point of sale (POS) summaries for the audit period; bank statements and sales and use tax returns (SUTRs) for the audit period; wine purchases for the year 2012; and an incomplete Bar Fact Sheet.⁴ Appellant did not provide a list of drink prices; records for catering sales or banquet sales; cash register z-tapes⁵ or POS reports; purchase journals; a general ledger; or records of the mandatory gratuities of 18 percent collected for parties of six or more.

³ While Judge Kwee was initially assigned to this panel and attended the hearing, he was later replaced with Judge Josh Aldrich. (Cal. Code Regs., tit. 18, § 30436(b).) Judge Aldrich thoroughly reviewed the record, hearing, and hearing transcript before participating in this opinion. The parties were notified of the substitution and given the opportunity to object and/or to request a new hearing prior to this opinion being issued. Both parties declined to do so.

⁴ A Bar Fact Sheet is a form that respondent's auditor gives to a taxpayer so that the taxpayer can list information regarding selling prices, happy hours, self-consumption, and other information pertinent to the audit.

⁵ A cash register z-tape is the portion of the cash register tape that summarizes sales by category for a certain period of time (i.e., a day or a shift).

4. In its preliminary review of the records, respondent found that the amounts of sales reported on FITRs reconciled with the amounts recorded in the P&Ls. However, it found material differences between the amounts of total sales reported on SUTRs and gross receipts reported on appellant's FITRs.⁶
5. For 2012, amounts reported on FITRs exceeded those reported on SUTRs by \$160,748, and for 2013, amounts reported on SUTRs exceeded those reported on FITRs by \$4,908. For 2014, the amounts substantially reconciled.
6. Respondent also found that appellant's bank deposits for the period April 1, 2012, through December 31, 2014, exceeded reported total sales by \$900,253.
7. Respondent used the gross receipts and costs of goods sold reported on appellant's FITRs to compute book markups⁷ of 184 percent⁸ for 2012, 190 percent for 2013, and 166 percent for 2014.⁹ Respondent considered the book markups much lower than expected, particularly since the book markup for the prior audit period, which had been accepted by respondent, was 237 percent. Accordingly, respondent concluded that further investigation was warranted.
8. Respondent initially conducted the audit on a markup basis. Appellant disputed respondent's use of the markup audit method, and respondent decided to conduct a reconciliation of bank deposits¹⁰ and reported sales.

⁶ For 2012, amounts reported on FITRs exceeded those reported on SUTRs by \$160,748, and for 2013, amounts reported on SUTRs exceeded those reported on FITRs by \$4,908. For 2014, the amounts substantially reconciled.

⁷ "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 $\text{markup amount} \div \text{cost}$. In this example, the markup percentage is 42.86 percent ($.30 \div .70 = 0.42857$). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

⁸ Amounts are rounded.

⁹ However, respondent noted in its Decision that the book markups should have been computed using the total sales reported on SUTRs, rather than the amounts reported on FITRs. The correct book markups would have been 44 percent for 2012, 192 percent for 2013, and 166 percent for 2014. Percentages are rounded.

¹⁰ 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 because of a lack of adequate records. (R&TC, § 6481.)

9. In a revised audit, respondent used an analysis of bank deposits to establish an understatement of reported taxable sales of \$702,750 and an unreported cost of self-consumed taxable merchandise of \$42,186.
10. On June 2, 2017, respondent issued an NOD for tax of \$58,920.20, plus applicable interest.
11. On July 2, 2017, appellant filed a petition for redetermination.
12. On March 20, 2020, respondent issued a Decision in which it ordered a reaudit to make an adjustment for \$40,000 of loan proceeds included in bank deposits and to allow appellant to provide evidence to support its arguments that 1) optional tips were included in bank deposits; and 2) adjustments were warranted concerning Groupon Deal-of-the-Day Instruments.¹¹
13. During the reaudit, appellant provided POS records from which respondent computed that 69.34 percent of the tips paid by customers were optional tips, and the remainder were taxable mandatory tips.¹²
14. During the reaudit, appellant provided POS records for July 2012 and March 2014. For July 2012, appellant's records showed that tips were paid in cash to employees. However, for March 2014, appellant provided evidence of payment of tips by check to employees. Accordingly, respondent concluded that appellant had paid tips in cash prior to March 2014. Respondent further concluded that the cash used to pay tips would have been provided to employees directly and would not have been deposited in the bank. Therefore, respondent adjusted the bank deposit totals for 69.34 percent of the tips recorded by appellant for the period March 1, 2014, through March 31, 2015.

¹¹ During the appeal with respondent, appellant argued that Groupon collected sales tax reimbursement with respect to its sales of coupons. On that basis, appellant asserted that a customer would be double-taxed if appellant collected sales tax reimbursement when the Groupon coupons were redeemed. Respondent stated it made no adjustment with respect to Groupon coupons in the reaudit because appellant did not provide supporting evidence. Appellant has not raised this issue in the appeal with OTA, and it is not relevant since the reaudit was conducted based on an analysis of bank deposits. Therefore, this issue will not be addressed further.

¹² Appellant has not disputed respondent's assertion that 30.66 percent (100 percent – 69.34 percent) were mandatory tips subject to tax.

15. Respondent conducted a reaudit in which it reduced the audited understatements based on a bank deposit reconciliation by \$187,495 (\$40,000 loan proceeds + 155,022 optional tips paid by check - \$7,527),¹³ from \$675,034 to \$487,539.
16. On November 20, 2020, respondent sent appellant a notice of the reaudit results, which stated that the audited understatement of tax had been reduced to \$41,706.
17. This timely appeal followed.

DISCUSSION

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, § 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, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).)

¹³ When respondent made the adjustments to bank deposits for the fourth quarter 2014 (\$40,000 for loan proceeds and \$43,181 for optional tips deposited in the bank), the net amount of bank deposits was \$337,636, which was \$7,527 less than the \$345,163 in reported total sales, net of tax, for that period. Respondent concluded, for that quarter, that appellant had properly reported its total sales, and it did not allow the adjustment for \$7,527.

An optional payment designated as a tip, gratuity, or service charge is not subject to tax. However, a mandatory payment designated as a tip, gratuity, or service charge is included in taxable gross receipts, even if the amount is subsequently paid by the retailer to employees. (Cal. Code Regs., tit. 18, § 1603(g), (h).)¹⁴

For this audit, appellant did not provide complete books and records, and there were conflicts in the available records. In addition, the book markups were much lower than respondent expected, based on its audit of appellant for the years 2009 through 2011.¹⁵ Under these circumstances, respondent reasonably concluded that appellant's records were not reliable and that it was necessary to utilize an indirect audit method. Initially, respondent used the markup method, which was appropriate for this type of business. (*Maganini v. Quinn*, (1950) 99 Cal.App.2d 1; see also *Riley B's Inc. v. State Bd. Of Equalization* (1976) 61 Cal.App.3d 610, 612-613.) However, appellant disputed the audit findings and requested that respondent use a different audit method. To accommodate appellant's request, respondent used a bank deposit analysis to establish the understatement. During the two reaudits, respondent adjusted the bank deposits for funds from sources other than sales that were documented by appellant; those sources included transfers between accounts, loan proceeds, and optional tips that were deposited in the bank and then paid to employees by check. Respondent then compared the remaining bank deposits, which represent funds from appellant's sales, to reported amounts to establish the audited understatement of reported taxable sales. Given all of these facts, OTA finds that respondent has used the bank deposit methodology correctly to calculate appellant's unreported taxable sales, and respondent has shown that its determination is reasonable and rational. Therefore, appellant has the burden to establish that further adjustments are warranted.

Appellant argues that there should be a larger adjustment for tips included in the amounts deposited in the bank. Appellant states that it has provided plenty of support to demonstrate its "tip out" policy. Appellant states further that its tip policy has never been disputed during any

¹⁴ Subsection (g) of California Code of Regulations, title 18, section 1603 applies to the period prior to January 1, 2015, while subsection (h) applies to the period after January 1, 2015.

¹⁵ The prior audit period ended just three months before the audit period under consideration here.

audit of the business over the past 35 plus years.¹⁶ Appellant asserts that respondent accepted some support documentation while rejecting other evidence appellant provided to show that it deposited tips in the bank and then paid the tips by check to its employees.

Respondent argues that appellant provided checks and other supporting documents for July 2012 and March 2014 to demonstrate its tips policy and to show that optional tips were deposited in the bank and paid to employees by check. According to respondent, the evidence provided for March 2014 established that optional tips were paid to employees by check. However, the documents provided for July 2012 showed that appellant had paid cash tips to employees. Accordingly, respondent concluded that appellant had used cash receipts to pay tips and had not deposited those receipts in the bank.

In response, appellant argues that it has always paid tips to its employees by check. Appellant has stated that it does not pay any cash tips. Appellant asserts that entries of “Cash Tip” do not refer to amounts paid in cash, but represent the tip amount paid by check. Respondent argues that appellant has not documented that it paid tips to employees by check prior to March 2014.

As evidence, appellant has provided a schedule of total tips for the audit period, and it has applied percentages to compute the amounts of optional tips included in the total for each month of the audit period. Although respondent does not concede that appellant paid tips to employees by check prior to March 2014, it has concluded that the percentages computed by appellant appear accurate.

For the months of July 2012 and July 2013, appellant has provided lists of checks issued to employees for tips. For each check, the lists show the date of the check, the number of the check, and the employee to whom the check was issued. For each entry on each list, appellant has provided accounting records, which appear to be entries into some sort of computer bookkeeping program (appellant has referred to QuickBooks). For each bookkeeping entry, the category shown is 20900 “Tip Out Account.” The accounting entries support the lists of checks for each month, with no discrepancies.

¹⁶ This assertion is not entirely clear because respondent states that there has been only one prior audit of appellant and that payment of tips to employees by check was not an issue in the prior audit. Also, appellant’s seller’s permit was issued in November 2004, only eight years before the beginning of the audit period at issue. However, these discrepancies regarding appellant’s time in business and prior audits do not impact the analysis in this appeal.

Appellant also provided copies of checks issued to employees. Although the checks are nearly illegible, appellant has typed information under each check, and the writing on the checks, as best as can be determined, corresponds to the typed information. Appellant provided checks corresponding to 18 of the 38 accounting entries¹⁷ for July 2012, and 39 of the 52¹⁸ accounting entries for July 2013.

Respondent disputes appellant's argument that tips were deposited in the bank account and paid to employees by check prior to March 2014. Respondent has presented evidence that appellant paid tips by cash in July 2012. Specifically, on audit workpaper Schedule 12A-4 R3, column U has scheduled tips of \$3,825.43 that were paid to employees as cash in July 2012. Respondent has also made computations related to several checks recorded in appellant's payroll record that effectively contradict appellant's statement (e.g., a check for pay of \$178.80, cash tip of \$180 and deductions of \$28.60, with net pay of \$150.20 (\$178.80 - \$28.60).)¹⁹ In addition, respondent has provided a copy of appellant's balance sheet for 2012, received during the audit, which does not include an account titled "Tip Out Account" (the reference on the accounting entries appellant provided as evidence). Further, respondent asserts that appellant has not provided complete payroll records, although respondent requested those records several times.

In response to OTA's additional briefing request regarding the difference between available records to support tips paid by check after March 2014 and the available records for periods prior to March 2014, respondent stated that, for the period after March 2014, appellant provided payroll records, bank statements, and POS reports, which showed that appellant had deposited all tips in bank accounts and paid tips with checks. According to respondent, the records appellant provided for periods prior to March 2014 are not as complete. With the exception of POS reports, the evidence described by respondent for the later period appears similar to the evidence appellant has provided for the earlier period.

¹⁷ Appellant did not provide copies of check numbers 33570 and all of the checks related to tips that were in the check sequence from 33592 through 33631 (in that sequence, there were 19 checks related to tips).

¹⁸ Appellant did not provide copies of check numbers 40849, 40860, 40862, 40870, 40871, 40874, 40877, 40878, 40880, 40882, 40884, 40888, and 40918.

¹⁹ In its December 1, 2022 reply brief, appellant continues to argue that the checks provided by respondent do not show that appellant made cash tips. Appellant asserts that respondent is somehow accusing appellant of hiding tips. Respondent is asserting that based on its analysis of the randomly selected checks, the cash tips were not included in the check amount as claimed by appellant, therefore, such tips were paid in cash and not deposited into appellant's bank account. Therefore, respondent asserts that no adjustments are warranted to the audit findings based on the bank deposits.

Accordingly, there is one question to address in this matter: has appellant provided sufficient evidence to show that it deposited tips into the bank account and paid them to employees by check throughout the audit period? As discussed above, appellant has provided evidence of tips paid by check during July 2012 and July 2013, and respondent has provided evidence of tips paid to employees in cash during July 2012. Each party asserts that the method of payment it has documented is the only method appellant used to pay tips to employees. However, the two types of payment are not mutually exclusive. OTA finds that, during the period April 1, 2012, through February 28, 2014, appellant paid some tips to employees by check and paid other amounts of tips to employees by cash. Thus, because respondent has provided clear evidence of payments of tips by cash, appellant's assertion that it never paid tips in cash is rejected.

In addition, appellant has provided compelling evidence of payment of tips by check. For each tip, appellant has provided copies of accounting records that show amounts recorded in a "Tip Out Account." That account name is strong evidence that the payments were related to tips. Respondent's observation that there is no "Tip Out Account" on the balance sheet for 2012 does raise questions. Further, appellant's explanation, that the "Tip Out Account" may have been incorrectly coded on Quick Books, is not entirely convincing.

Appellant provided a list of employee paychecks. Eleven of those checks include a notation that indicates that tips were paid to the employee in cash. On that list, there are also several paychecks with no reference to tips. Several of the paychecks with no reference to tips are to employees who did in fact receive tips by check during the audit period (e.g., A. Frost, J. Gonzalez, R. Hernandez, and M. Poli). The absence of a reference to tips on those checks would show that either 1) the employees received no tips during the pay period or 2) the tips were paid to employees by check. OTA finds the second option is much more likely than the first.

Appellant has also provided copies of checks that correspond to the accounting entries for most of the recorded payments of tip by check. Although appellant has not provided a check for each accounting entry, the checks provided are sufficient to document the authenticity of the accounting entries and to establish that appellant's process was to pay certain tips to employees by check. In addition, appellant has provided affidavits and witness testimony from several

employees stating that tips were paid by check. This evidence supports the validity of the primary evidence provided by appellant.

One of respondent's concerns regarding the accuracy of appellant's list is that the total of accounting entries for July 2012 (\$12,499) plus the documented cash tips (\$3,825) total far more than the \$12,226 shown on appellant's list. Respondent argues that the difference is evidence that the list is inaccurate. OTA finds, instead, that the list represents only tips paid by check, since the total of the accounting entries is comparable to the amount shown on the list. The tips paid in cash are separate and not related to the analysis of tips paid by check.

OTA finds, by a preponderance of the evidence, that appellant paid some tips to employees in cash and paid some tips by check. For the two months that appellant provided documentation (the list of tips paid by check for the audit period, accounting entries, and copies of checks), the amounts of the checks were comparable, but not identical to the amounts on the list. Specifically, for July 2012, the total of accounting entries is \$12,499.36, while the total on appellant's list is \$12,226; for July 2013, the total of accounting entries is \$9,550.20, while the total on appellant's list is \$10,926. In consideration of this discrepancy, OTA finds that appellant has supported 95 percent of the entries on its list.²⁰ Also, the total adjustment of \$323,643 on appellant's list must be reduced by \$43,245, for the amount related to the first quarter 2012, which is outside the audit period.

In summary, OTA finds that the audited understatement of reported taxable sales should be reduced by \$266,378,²¹ from \$487,539 to \$221,161.

²⁰ $\$12,499.36 + \$9,550.20 = \$22,049.56$ total accounting entries for the two months. $\$12,226 + \$10,926 = \$23,152$ total list amounts for the two months. $\$22,049.56 \div \$23,152 = 95.24$ percent.

²¹ $\$323,643$ scheduled by appellant - $\$43,245$ for 1Q12 = $\$280,398$. $\$280,398 \times 95$ percent = $\$266,378$.

HOLDING

Appellant has established that further reduction of \$266,378 is warranted to the audited understatement of reported taxable sales.

DISPOSITION

Reduce the audited understatement of reported taxable sales from \$487,539 to \$221,161 and otherwise deny the petition for redetermination.

DocuSigned by:
Natasha Ralston
25E8EE08EE56478

Natasha Ralston
Administrative Law Judge

We concur:

DocuSigned by:
Josh Aldrich
48745BB806914B4...

Josh Aldrich
Administrative Law Judge

DocuSigned by:
Josh Lambert
CB1F7DA37831416...

Josh Lambert
Administrative Law Judge

Date Issued: 1/12/2024