

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:)	OTA Case No. 220510325
)	CDTFA Case ID 2-566-832
H. TRAN,)	
HOUSTON & HONOR, LLC, AND)	OTA Case No. 220510326
HOUSTON & HONOR, INC.,)	CDTFA Case ID 2-566-831
dba Signature Dessert and Signature Pho &)	
Desserts)	OTA Case No. 220510327
)	CDTFA Case ID 2-562-077
)	
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OPINION

Representing the Parties:

For Appellants: H. Tran, Representative

For Respondent: Jason Parker,
Chief of Headquarters Operations

For Office of Tax Appeals: Craig Okihara, Business Taxes Specialist III

L. KATAGIHARA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, H. Tran (Sole Proprietor), Houston & Honor, LLC (LLC), and Houston & Honor, Inc. (Corporation) (collectively, appellants) each appeal a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)¹ denying appellants’ respective petitions for redetermination of a Notice of Determination (NOD).

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

The NOD issued to Sole Proprietor is dated February 18, 2021,² and is for tax of \$11,118, plus applicable interest, and a negligence penalty of \$1,111.84, for the period January 1, 2017, through June 30, 2017 (Sole Proprietor's liability period).³

The NOD issued to LLC is dated February 18, 2021,⁴ and is for tax of \$113,454, plus applicable interest, and a negligence penalty of \$11,345.36, for the period May 1, 2017, through December 31, 2018 (LLC's liability period). During this appeal, CDTFA conceded that the NOD was untimely as to the period May 1, 2017, through June 30, 2017. Consequently, CDTFA prepared a reaudit to remove the liability associated with that period. The reaudit reduced the deficiency measure to \$1,330,034, which will result in a reduction to LLC's tax liability.

The NOD issued to Corporation is dated February 18, 2021, and is for tax of \$69,408, plus applicable interest, and a penalty of \$6,940.77, for the period January 1, 2019, through September 30, 2019 (Corporation's liability period). During this appeal, CDTFA prepared two reaudits, the second of which reduced the deficiency measure to \$755,871, which will result in a reduction to Corporation's tax liability.

Appellants waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

ISSUE

Whether appellants have established that further adjustments to the measures of unreported taxable sales are warranted.

² The NOD was timely issued because on April 16, 2020, Sole Proprietor signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period January 1, 2017, through June 30, 2017, which allowed CDTFA until April 30, 2021, to issue an NOD. (R&TC, §§ 6487(a), 6488.)

³ The NOD lists an audit period ending June 30, 2017, because Sole Proprietor's seller's permit was initially deemed closed on that date. CDTFA later corrected the close-out date to April 30, 2017. As the business stopped operating as a sole proprietorship on April 30, 2017, Sole Proprietor's NOD does not include a liability associated with the period May 1, 2017, through June 30, 2017.

⁴ The NOD was timely issued for the period July 1, 2017, through December 31, 2017, because on September 23, 2019, LLC signed a waiver of the otherwise applicable three-year statute of limitations which allowed CDTFA until April 30, 2021, to issue an NOD for that period. (R&TC, §§ 6487(a), 6488.) CDTFA did not obtain a valid waiver for the period May 1, 2017, through June 30, 2017, and therefore, the NOD was not timely as to that period.

FACTUAL FINDINGS

1. Sole Proprietor, dba Signature Dessert, operated a restaurant located in Laguna Niguel, California. Sole Proprietor's seller's permit was opened with an effective start date of January 1, 2017, and closed with an effective date of April 30, 2017, when the business was reorganized as a limited liability company.
2. LLC's seller's permit was opened with an effective start date of May 1, 2017.⁵ Under this seller's permit, LLC continued to operate the Laguna Nigel restaurant, but as Signature Pho & Desserts. LLC also opened a second location in Canyon Lake, California, which began operating on August 9, 2017. LLC's seller's permit was closed with an effective date of December 31, 2018, when the business was reorganized as a corporation.
3. Corporation's seller's permit was opened with an effective start date of January 1, 2019. Corporation continued to operate the same two restaurants. Corporation's seller's permit was closed with an effective date of September 30, 2019, when the business ceased operating.
4. CDTFA prepared a separate audit for each legal entity, each of which is described below.

Audit of Sole Proprietor (January 1, 2017, through April 30, 2017)

5. For the relevant liability period, Sole Proprietor reported total sales of \$31,450 on her sales and use tax returns (SUTRs), and claimed deductions of \$29,410 for nontaxable sales of food, resulting in taxable sales of \$2,040. Sole Proprietor stated that she prepared the SUTRs but was unable to explain the method she used for determining the amount of reported sales and claimed deductions. Sole Proprietor did not provide sales tax reports or worksheets to support her reported sales or claimed deductions.
6. For the audit, Sole Proprietor provided incomplete sales receipt books (referred to as sales notebooks)⁶ and various merchandise purchase records. Sole Proprietor also provided both a federal income tax return (FITR) and amended FITR for 2017. CDTFA, however, was unable to confirm that the amended FITR was filed with, and accepted by,

⁵ LLC's seller's permit was initially created with an effective start date of July 1, 2017. CDTFA later corrected the start date to May 1, 2017.

⁶ CDTFA noted that the information on the pre-numbered sales receipts were handwritten; missing customer information, dates, and payment methods; and appeared to have been recently created.

the IRS, and Sole Proprietor did not provide any support to justify the amendments therein. For these reasons, CDTFA disregarded the amended FITR. Sole Proprietor did not provide point-of-sale (POS) system sales detail reports or cash register z-tapes,⁷ bank statements, or source documentation (such as cash register receipt tapes) relevant to the liability period. CDTFA found the available books and records were inadequate for sales and use tax audit purposes.

7. CDTFA compared the total sales Sole Proprietor reported on her SUTRs for January 1, 2017, through April 30, 2017, to the gross receipts she reported on her FITR for the same period and found a large discrepancy between the two. Sole Proprietor could not provide an explanation for the difference. CDTFA also compared the gross receipts to the cost of goods sold that Sole Proprietor reported on her FITR and computed a book markup of 64.06 percent.⁸ CDTFA considered the book markup to be low for Sole Proprietor's type of business.⁹ As such, CDTFA concluded that Sole Proprietor's gross receipts were understated, and therefore, unreliable. CDTFA further concluded that these discrepancies were evidence that Sole Proprietor's reported total sales were understated.
8. To determine Sole Proprietor's audited taxable sales, CDTFA used the credit-card-sales-ratio method. To start, CDTFA obtained Form 1099-K¹⁰ data from the IRS, which reflected credit card sales of \$130,171 for Sole Proprietor's liability period.¹¹ To account for tips included in those credit card sales, CDTFA divided the credit card sales by one plus a credit card tip ratio of 10 percent, which resulted in \$118,337 in credit cards sales

⁷ A cash register z-tape is the portion of the cash register tape that summarizes sales by category for a certain time period (e.g., a day or a shift).

⁸ "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 $\text{markup amount} \div \text{cost}$. In this example, the markup percentage is 42.86 percent ($0.30 \div 0.70 = 0.42857$). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

⁹ CDTFA did not indicate what they would consider to be a reasonable markup for any of appellants' businesses.

¹⁰ Federal Form 1099-K is used to report a taxpayer's income received from electronic or online payment services (credit cards, debit cards, PayPal, etc.). Its use for tax administration purposes is authorized by the IRS.

¹¹ April 2017 credit card sales were reflected on LLC's Form 1099-K; CDTFA only incorporated those sales in Sole Proprietor's audit and not in LLC's audit.

excluding tips.¹² CDTFA also accounted for sales tax included in the credit card sales by dividing \$118,337 by one plus the sales tax rate in effect (7.75 percent), which resulted in \$109,826 in credit card sales excluding tips and sales tax. Next, CDTFA estimated, based on its experience auditing similar businesses in Sole Proprietor's area, that 75.55 percent of Sole Proprietor's sales were paid by credit card (credit card sales ratio).¹³ Therefore, to incorporate cash sales, CDTFA divided the credit card sales (excluding tips and sales tax) by the 75.55 percent credit card sales ratio to compute audited taxable sales of \$145,365 for Sole Proprietor's liability period.

9. By comparing the audited taxable sales of \$145,365 to Sole Proprietor's reported taxable sales of \$2,040, CDTFA computed unreported taxable sales of \$143,325 for the liability period.
10. CDTFA further noted that all of Sole Proprietor's taxable sales were subject to the Orange County Transportation Authority district tax (OCTA tax), but Sole Proprietor's SUTRs did not report any sales subject to the OCTA tax. As Sole Proprietor reported taxable sales of \$2,040, CDTFA established a separate deficiency measure of \$2,040 subject to only the OCTA tax.¹⁴
11. Based on this audit, CDTFA issued the NOD to Sole Proprietor on February 18, 2021, with a tax liability of \$11,118, plus applicable interest, and a negligence penalty of \$1,111.84.¹⁵

Audit of LLC (May 1, 2017, through December 31, 2018)

12. For LLC's liability period, LLC reported on its SUTRs total sales of \$118,154 and claimed deductions of \$58,730 (\$21,994 for nontaxable sales of food, \$20,096 for nontaxable labor, and \$16,640 for sales for resale), resulting in taxable sales of \$59,424. LLC stated that Sole Proprietor (a member of LLC) prepared the SUTRs. However, LLC

¹² Sole Proprietor did not provide substantiation that tips were included in any of the credit card sales (as opposed to being paid in cash), but CDTFA provided the adjustment to Sole Proprietor's benefit.

¹³ CDTFA used an estimation because Sole Proprietor's records were inadequate to perform an analysis on an actual basis and the audit did not begin until after the business discontinued operations.

¹⁴ Sole Proprietor has not disputed this audit item on appeal; thus, OTA does not discuss it further.

¹⁵ Sole Proprietor has not disputed the negligence penalty on appeal; thus, OTA does not discuss it further.

- was unable to provide supporting sales tax worksheets or explain the method used for determining the amount of reported sales and claimed deductions.
13. For its audit, LLC provided the following books and records: FITRs for 2017 and 2018; bank statements for the duration of LLC's liability period; incomplete sales receipt books; and various merchandise purchase records. LLC did not provide POS sales detail reports, cash register z-tapes, or source documentation relevant to LLC's liability period. CDTFA concluded the available books and records were inadequate for sales and use tax audit purposes.
 14. Using LLC's FITRs for May 1, 2017, through December 31, 2017, and for 2018, CDTFA mirrored the analysis it performed with Sole Proprietor's FITR. Again, CDTFA found disparate and unexplained differences between the FITRs and SUTRs and a low FITR book markup of 96.04 percent, which indicated to CDTFA that LLC's reported sales and gross receipts were both understated.
 15. Therefore, to determine LLC's audited taxable sales, CDTFA used the credit-card-sales-ratio method. LLC's bank statements¹⁶ reflected \$1,364,114 in credit card deposits (which was further supported by 1099-K data reflecting credit card sales of \$1,333,169), \$190,128 in cash deposits, and an online transfer of \$89,323. CDTFA determined that these deposits, totaling \$1,643,565, constituted sale proceeds.
 16. CDTFA concluded that the credit card tip ratio and credit card sales ratio used in the audited taxable sales calculation for Sole Proprietor's audit were also representative of LLC's business.¹⁷ Therefore, CDTFA divided LLC's credit card deposits by one plus the estimated credit card tip ratio of 10 percent, and divided that result by one plus the 7.75 percent sales tax rate in effect to compute LLC's credit card sales, excluding tips and sales tax. CDTFA then divided that amount by the credit card sales ratio of 75.55 percent to calculate audited taxable sales of \$1,523,340 for LLC's liability period.

¹⁶ Bank deposits are not gross receipts. (See 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. CDTFA can use this evidence to determine audited taxable sales when sales cannot be accurately established using a direct approach due to a lack of adequate records.

¹⁷ In its response to OTA's request for additional briefing, CDTFA provided evidence that, based on a sample of audits CDTFA previously conducted with liability periods spanning between 2017 and 2022, restaurants in Riverside County had an average credit card sales ratio of 65.68 percent. Therefore, CDTFA's use of the 75.55 percent credit card ratio resulted in a benefit to LLC.

17. By comparing the audited taxable sales of \$1,523,340 to LLC's reported taxable sales of \$59,424, CDTFA computed unreported taxable sales of \$1,463,916 for the liability period.
18. Based on this audit, CDTFA issued the NOD to LLC on February 18, 2021, with a tax liability of \$113,454, plus applicable interest, and a negligence penalty of \$11,345.36.¹⁸
19. During briefing for these appeals, CDTFA conceded that the statute of limitation waiver it obtained for the period May 1, 2017, through June 30, 2017, was not valid as to LLC. Thus, the NOD was not timely issued to LLC for that period.
20. Consequently, CDTFA prepared a reaudit report dated March 1, 2023, to delete the unreported taxable sales associated with the period May 1, 2017, through June 30, 2017. CDTFA's reaudit report reduced LLC's unreported taxable sales to \$1,330,034, which is the taxable measure remaining in dispute for LLC.

Audit of Corporation (January 1, 2019, through September 30, 2019)

21. For Corporation's liability period, Corporation filed SUTRs reporting zero sales.
22. For its audit, Corporation provided the following books and records: its 2019 FITR; bank statements for the entirety of Corporation's liability period; incomplete sales receipt books; and various merchandise purchase records. Given that Corporation's source documentation was incomplete or lacking (e.g., no POS reports or cash register z-tapes were provided), CDTFA found the available books and records were inadequate for sales and use tax audit purposes.
23. Although Corporation reported zero sales on its SUTRs, Corporation reported gross receipts of \$682,171 on its 2019 FITR. Corporation asserted that its gross receipts constituted various nontaxable sales but conceded that it did not maintain documentation relevant to sales.¹⁹ CDTFA concluded that the difference was evidence that Corporation failed to report taxable sales. Using Corporation's FITR, CDTFA computed a book markup of 117.43 percent, which CDTFA considered low for Corporation's type of business. Therefore, CDTFA determined the FITR to be unreliable.

¹⁸ LLC has not disputed the negligence penalty here; thus, OTA does not discuss it further.

¹⁹ Corporation later provided some documents to CDTFA, but CDTFA deemed the documents to be irrelevant to Corporation's liability period or to be unreliable.

24. Consequently, CDTFA used the credit-card-sales-ratio method to compute Corporation's audited taxable sales.
25. Corporation's bank statements reflected \$801,974 in credit card deposits and \$272,297 in cash deposits, for a total of \$1,074,271 in bank deposits related to sale proceeds.
26. CDTFA concluded that the credit card tip ratio and credit card sales ratio used in the audited taxable sales calculation for Sole Proprietor and LLC's audit were also representative of Corporation's business. Therefore, CDTFA divided Corporation's credit card deposits by one plus the estimated credit card tip ratio of 10 percent and divided that result by one plus the 7.75 percent sales tax rate in effect to compute LLC's credit card sales, excluding tips and sales tax. CDTFA then divided that amount by the credit card sales ratio of 75.55 percent to calculate audited taxable sales of \$895,584. This amount also represented the measure of tax as Corporation did not report any taxable sales on its SUTRs.
27. CDTFA issued the NOD to Corporation on February 18, 2021, based on the above-mentioned audit, with a tax liability of \$69,408 plus applicable interest, and a negligence penalty of \$6,940.77.²⁰
28. During briefing, CDTFA determined that two of the bank deposits (totaling \$125,109) it previously considered to be sale proceeds should be treated as loans. CDTFA's allowance reduced Corporation's credit card deposits, which in turn, reduced Corporation's audited taxable sales. CDTFA, therefore, prepared a second reaudit report²¹ dated June 30, 2022, that decreased Corporation's unreported taxable sales to \$755,871, which is the taxable measure remaining in dispute for Corporation.
29. Appellants each filed a timely petition for redetermination of their respective NODs. After CDTFA's appeals conference, appellant submitted additional documentation to CDTFA for consideration, including (but not limited to) POS reports and cash register z-tapes for a 10-day period; nine months of banks statements; a construction business license; and several sales invoices associated with August 2019. CDTFA determined the additional documentation was unreliable (because it was either not supported by

²⁰ Corporation has not disputed the negligence penalty here; thus, OTA does not discuss it further.

²¹ CDTFA's first reaudit (dated June 22, 2022) provided the same loan allowance, but inaccurately used a total of \$120,109, rather than \$125,109. Thus, CDTFA prepared a second reaudit shortly thereafter to rectify its mistake.

sufficient evidence or contradicted by other evidence) or irrelevant (because it was not associated with the liability periods at issue). Thus, CDTFA disregarded appellant's post-conference submission.

30. CDTFA denied all three petitions for redetermination, and 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.) Although gross receipts from the sale of "food products" are generally exempt from the sales tax, sales of hot food and sales of food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (d)(2), and (d)(7).) 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).)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, CDTFA may determine the amount required to be paid on the basis of any information 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 Talavera*, 2020-OTA-022P.) Once CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to establish, by a preponderance of the evidence, that a result differing from CDTFA's determination is warranted. (*Ibid.*; Cal. Code Regs., tit. 18, § 30219(a) & (b).) To satisfy its burden of proof, a taxpayer must prove both: (1) that the tax assessment is incorrect, and (2) the proper amount of tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) A taxpayer cannot carry its burden simply by asking OTA to find unidentified errors in CDTFA's determination. (*Appeal of Amaya*, 2021-OTA-328P.)

Here, the books and records appellants provided to CDTFA were incomplete and inadequate for sales and use tax audit purposes. Due to the lack of substantiating documents, CDTFA was unable to verify appellants' reported sales using a direct audit method (that is, by compiling audited sales directly from appellants' records). For each of appellants' respective

audits, CDTFA’s discovered both low book markups²² and significant discrepancies between appellants’ available records, which were indications that appellants’ reported taxable sales were understated. When a restaurant that accepts credit cards does not provide CDTFA with books and records sufficient to verify the accuracy of reported sales using a direct audit approach, it is appropriate for CDTFA to utilize the credit-card-sales-ratio method, an indirect audit approach. (*Appeal of Amaya, supra.*) Accordingly, CDTFA’s use of the credit-card-sales-ratio method was appropriate here.

Moreover, the Form 1099-K data and credit card bank deposits constitute reliable evidence from a third party (i.e., merchant card processors) of appellants’ sales from which CDTFA could establish audited sales. Therefore, CDTFA has established that its determinations are reasonable and rational, and accordingly, the burden shifts to appellants to establish that adjustments are warranted.

Appellants assert they have submitted to CDTFA all documents available to support their reported sales, but appellants have not specified the adjustments they believe are warranted. Therefore, OTA requested additional briefing to provide appellants the opportunity to identify, and provide support for, the adjustments they seek. In response, appellants reiterated their disagreement with CDTFA’s determinations, but did not identify any specific contentions or errors with the audits.²³ Instead, appellants requested relief on the basis of financial hardship and also requested a “public defender” to assist with their appeals.

As previously stated, to meet their burden, appellants must identify the alleged errors and provide evidence sufficient to establish that a result differing from CDTFA’s determinations is warranted. (*Appeal of Talavera, supra.*) Because appellants failed to do either, OTA has no basis to recommend an adjustment.

²² OTA recognizes that Corporation’s book markup was higher than CDTFA’s audited markup of LLC. Given that Corporation argued both that the gross receipts reported in the FITR were comprised of only nontaxable sales, and that Corporation made no taxable sales (even though the business was still operating), OTA finds that the FITR was not a reliable source from which CDTFA could have determined the proper amount of tax.

²³ On October 3, 2022, appellants requested a 60-day extension to seek legal representation and file their additional brief. OTA granted appellants’ request and provided a response deadline of December 19, 2022. However, as of the date of this Opinion, appellants have not provided any additional briefing or otherwise responded.

With respect to appellants’ requests, there is no provision in the Sales and Use Tax Law that allows OTA to relieve tax liability based on financial hardship. In addition, appellants’ request for government-sponsored representation is outside of OTA’s purview.

HOLDING

Appellants have not established that further adjustments to the measures of unreported taxable sales are warranted.

DISPOSITION

CDTFA’s action in denying the petition for Sole Proprietor is sustained. CDTFA’s action in reducing LLC’s deficiency measure to \$1,330,034, but otherwise denying LLC’s petition, is sustained. CDTFA’s action in reducing Corporation’s deficiency measure to \$755,871, but otherwise denying Corporation’s petition, is sustained.

DocuSigned by:
Lauren Katagihara
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Lauren Katagihara
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
CB1F7DA37831416...
Josh Lambert
Administrative Law Judge

DocuSigned by:
Suzanne B. Brown
47F45ABE89E94D0...
Suzanne B. Brown
Administrative Law Judge

Date Issued: 12/1/2023