OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **MARIO'S PLACE, INC.**	OTA Case No. 21068102 CDTFA Case ID: 980-077

OPINION

Representing the Parties:

For Appellant:	Dwight M. Montgomery, Attorney
For Respondent:	Nalan Samarawickrema, Hearing Representative Christopher Brooks, Attorney Jason Parker, Chief of Headquarters Ops.
For the Office of Tax Appeals:	Richard Zellmer, Business Taxes Specialist III

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Mario's Place, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) denying appellant's petition for redetermination of a Notice of Determination (NOD) dated January 30, 2019.[1] The NOD is for a tax liability of $50,520, plus applicable interest, for the period July 1, 2014, through December 31, 2017 (audit period).

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

ISSUE

Whether the deficiency amount should be reduced.

FACTUAL FINDINGS

1. Appellant operated a full-service restaurant with a bar in Riverside, California.

[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. For the audit period, appellant claimed no deductions and reported total/taxable sales of $11,085,097. Appellant also reported purchases of $10,928 subject to use tax.

3. Appellant used its point-of-sale (POS) system to record its sales and based its reported taxable sales on its monthly sales tax worksheets and monthly sales journals. Appellant netted recorded exempt sales from total sales (that is, appellant did not report the recorded exempt sales on its sales and use tax returns).

4. For the audit, appellant provided the following books and records: federal income tax returns for fiscal years ending (FYE) May 31, 2014, and May 31, 2015;[2] a sales journal report showing summary sales information downloaded from the POS system for the audit period (summary sales journal report);[3] monthly summary sales tax worksheets for July 2014 through March 2017; profit and loss statements for FYE May 31, 2014, and May 31, 2015; and some contracts under which appellant made sales to customers for banquets and other special events (hereafter, "banquet contracts"). The summary sales journal report and monthly summary sales tax worksheets did not provide information regarding individual sales. Appellant did not provide sales receipts, guest checks, or any other record of individual sales.

5. Based on its examination of appellant's books and records and the general nature of appellant's business, CDTFA concluded that over 80 percent of appellant's sales were sales of food products, and over 80 percent of appellant's food sales were subject to tax. Thus, CDTFA concluded that, generally, all of appellant's sales were taxable under the 80-80 Rule.[4]

---

[2] Appellant's fiscal year was from June 1st of one year to May 31st of the next year.

[3] It appears that this summary sales journal report, which appellant produced from its POS system, provides amounts for various categories of sales for the entire audit period, but does not provide monthly or quarterly totals. As explained below, CDTFA allocated the audit-period totals from this summary sales journal report into the various quarters of the audit period by dividing the audit-period totals by 14 quarters.

[4] The general rule is that a sale of cold food to-go is exempt from tax. (Cal. Code Regs., tit. 18, § 1603(c)(1)(B).) However, there is a special 80-80 Rule under which a sale of cold food to-go in a form suitable for consumption on the retailer's premises (e.g., a cold sandwich) is subject to tax. This rule applies when more than 80 percent of a retailer's gross receipts are from sales of food products, and more than 80 percent of the retailer's sales of food are otherwise subject to tax. (R&TC, § 6359(d)(6); Cal. Code Regs., tit. 18, § 1603(c)(1)(A), (3).) However, even when a retailer meets the criteria of the 80-80 Rule, it may avoid its application by keeping a separate accounting of its sales of cold food to-go in a form suitable for consumption on the retailer's premises. (R&TC, § 6359(f); Cal. Code Regs., tit. 18, § 1603(c)(1)(A).) Therefore, where a retailer separately accounts for these sales, they are exempt from tax, but if the retailer does not do so, these sales are subject to tax unless the retailer does not meet the criteria of the 80-80 Rule.

6. CDTFA examined the summary sales journal report and noted an entry of $1,808,866 that was designated as "TIPS TO SERVERS." CDTFA concluded that these were optional tips appellant paid directly to employees that were not subject to tax.
7. CDTFA also noted in the summary sales journal report three separate entries of $1,583.62, $8,737.01, and $387,989.34 (totaling $398,309.97), which were designated as "GRATUITIES." These entries appeared next to corresponding entries of "0.00" under a column heading of "TAX." CDTFA found that these entries totaling $398,310 (rounded) were not optional tips paid to servers because these entries were recorded separately from the $1,808,866 amount. CDTFA also noted that the entries totaling $398,310 "appear to be taxable" because, although no tax was added to them, they were associated with a taxable category per the "TAX" column heading. CDTFA further noted that some of the banquet contracts contained provisions indicating that the customers agreed to pay appellant a 20 percent gratuity or that appellant would add a gratuity to the bill. CDTFA determined that the $398,310 amount was likely related to mandatory gratuities associated with the banquet contracts. Additionally, CDTFA found that appellant could not satisfactorily explain why the $398,310 in revenue should be regarded as nontaxable or exempt. Thus, CDTFA concluded that the $398,310 amount constituted mandatory taxable tips.
8. CDTFA then divided the $398,310 amount by 14 (the number of quarters in the audit period) to compute a quarterly average of $28,451 for the audit period. CDTFA then multiplied the $28,451 amount by 14 quarters to compute unreported mandatory payments designated as gratuities of $398,314 (there is an immaterial rounding difference of $4 here).
9. As a result of the audit, CDTFA ultimately determined a total understatement of $621,041, which included unreported mandatory payments designated as gratuities of $398,314, which are subject to tax.
10. CDTFA issued to appellant the NOD, which appellant petitioned.
11. CDTFA denied appellant's petition, and this timely appeal to OTA followed.
12. On appeal to OTA, appellant only contests the gratuity issue.

DISCUSSION

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sale of all tangible personal property sold in this state. (R&TC, § 6051.) "Gross receipts" means the total amount of the sale price of the retailer's retail sale, including any services that are part of the sale. (R&TC, § 6012(a), (b).) "Sale" means and includes the furnishing, preparing, or serving of food, meals, or drinks for a consideration. (R&TC, § 6006(d).) Whether a payment designated as a tip, gratuity, or service charge is included in taxable gross receipts depends on whether the payment is "optional" or "mandatory." (*GMRI, Inc. v. Cal. Dept. of Tax & Fee Admin.* (2018) 21 Cal.App.5th 111, 125.)

An optional payment designated as a tip, gratuity, or service charge is not subject to tax. (Cal. Code Regs., tit. 18, § 1603(g), (h).) A tip, gratuity, or service charge is considered optional if the customer adds the amount to the bill or leaves a separate amount in addition to the actual amount due for the sale of meals, food, and drinks that include services. (Cal. Code Regs., tit. 18, § 1603(g)(1).) Beginning January 1, 2015, a tip, gratuity, service charge, or any other separately stated payment for services associated with the purchase of meals, food, or drinks (hereafter, "amount(s)") is presumed to be optional and not subject to tax if the retailer keeps records consistent with reporting these amounts as tip wages for IRS purposes. (Cal. Code Regs., tit. 18, § 1603(h)(1).)

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).) These amounts will be considered mandatory when (A) the amount is negotiated between the retailer and customer in advance of a meal, food, or drinks, or an event that includes the same, or (B) the menu, brochure, advertisement, or other printed materials notifies customers that tips, gratuities, or service charges will or may be automatically added and the retailer does in fact add such charges to the bill or invoice paid by the customer. (Cal. Code Regs., tit. 18, § 1603(g)(2)(A) & (B), (h)(3)(A) & (B).) Any amount added by the retailer to the bill is presumed to be automatically added and mandatory. (Cal. Code Regs., tit. 18, § 1603(g)(2)(B), (h)(3)(B).) This presumption may be controverted by documentary evidence showing that the customer specifically requested and authorized the amount to be added to the bill. (Cal. Code Regs., tit. 18, § 1603(g)(2)(C), (h)(3)(C).) Beginning January 1, 2015, if a retailer's records show that amounts are required to be reported to the IRS

as non-tip wages, then the amount is deemed mandatory. (Cal. Code Regs., tit. 18, § 1603(h)(2).)

If CDTFA is not satisfied with the amount of tax required to be paid to the state by any person, CDTFA may compute and 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.)

In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.) If the audit or statistical method used by CDTFA to calculate or to estimate a determination is not rational, then the determination should be rejected. (See *Appeal of Praxair, Inc.*, 2019-OTA-301P, at p. *22 [rejecting an audit method in which CDTFA estimated and projected a taxable ratio because CDTFA's approach failed to consider documentary evidence and testimony]; see also *In re Renovizor's, Inc.* (9th Cir. 2002) 282 F.3d 1233, 1237, fn. 1.) If the method is rational, then CDTFA's determination is presumed correct. (See *In re Renovizor's, Inc.*, *supra*, 282 F.3d at 1237, fn. 1; see also *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 445 (*Paine*).) The burden of overcoming this presumption is on the taxpayer. (*Paine*, *supra*, 137 Cal.App.3d at p. 445.)

The appellant bears the burden of proof as to all issues of fact unless the law specifies otherwise. (Cal. Code Regs., tit. 18, § 30219(a).) The standard of proof is by a preponderance of the evidence unless the law also specifies otherwise. (Cal. Code Regs., tit. 18, § 30219(b).) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Las Playas #10, Inc.*, *supra*.)

Here, CDTFA found two entries in appellant's summary sales journal report: $1,808,866 designated as "TIPS TO SERVERS;" and $398,310 designated as "GRATUITIES." CDTFA noted that some of appellant's banquet contracts required mandatory gratuities of 20 percent. CDTFA concluded that the tips-to-servers journal entry was for optional nontaxable tips paid directly to servers, but that the gratuities journal entry represented mandatory taxable charges.

OTA finds that it was reasonable for CDTFA to conclude that the two journal entries at issue represented different types of revenue because each entry had a different name or designation in appellant's summary sales journal. Further, the available banquet contracts requiring gratuities indicate that the amount of the gratuities and other mandatory payments were negotiated in advance of the banquets and mandatory. Finally, appellant did not provide any

documentation showing that appellant's customers specifically requested or authorized such gratuities be added to the banquet bills (which would have suggested that they were optional and nontaxable) or that the revenue designated as gratuities was otherwise exempt or nontaxable. Appellant has not provided documentation identifying any individual transaction relating to the $398,310 in gratuities recorded in its summary sales journal report. Based on the forgoing, OTA finds that it was reasonable and rational for CDTFA to conclude that the revenue designated as gratuities is subject to tax; accordingly, CDTFA's determination is presumed correct. The burden of proof now shifts to appellant to overcome that presumption.

On appeal, appellant makes three arguments: (1) CDTFA has not proven that the journal entries labeled "GRATUITIES" represent mandatory taxable gratuities; (2) regardless of the contract provisions, appellant did not require customers to make mandatory payments as part of the banquet contracts because doing so would be detrimental to its business; and (3) the gratuities of $398,310 are duplicated in the $1,808,866 amount labeled as tips to servers. OTA will address each of these arguments in turn.

Regarding appellant's first argument that CDTFA has not proven that the journal entries labeled "GRATUITIES" represent mandatory taxable gratuities, OTA has already analyzed the evidentiary record and found that CDTFA acted reasonably and rationally in treating the amounts recorded as gratuities as mandatory and taxable. Thus, CDTFA's determination is presumed correct, and the burden of proof shifts to appellant to show that some or all of the gratuities in question are not subject to tax. For its part, appellant has not provided any documentation showing that the $398,310 recorded in its records as gratuities is nontaxable or exempt. Ultimately, OTA is not persuaded by appellant's first argument.

Regarding appellant's second argument that it did not require customers to make mandatory payments because doing so would be detrimental to its business, the evidence shows that some of appellant's banquet contracts contained provisions indicating that the customers agreed to pay appellant a mandatory 20 percent gratuity or that appellant would add a gratuity to the contract amount. Appellant has not provided evidence showing that it did not enforce these contractual provisions. Nor has appellant provided evidence showing that its banquet-contract customers only paid appellant the contracted amounts for food, beverages, and room rental, and that such payments did not include amounts for gratuities or other mandatory charges. Accordingly, OTA finds appellant's second argument lacking in merit.

In support of its third argument that the $398,310 amount designated as gratuities is duplicated in the $1,808,866 amount labeled as tips to servers, appellant calculated that the $398,310 amount represents 42 percent of the banquet contract amounts totaling $953,709. Appellant contends that it is unreasonable to presume that mandatory gratuities represent 42 percent of total banquet contract charges, especially since some of the banquet contracts call for a gratuity of only 20 percent. Thus, appellant argues that the $398,310 of gratuities at issue should not be regarded as connected to the banquet contracts but should instead be regarded as part of optional nontaxable "TIPS TO SERVERS."

As noted above, OTA found it reasonable to conclude that journal entries with different labels or names represent different types of transactions. Appellant has not explained why it would have taken a portion of the revenue labeled as "TIPS TO SERVERS" and duplicated those transactions in a separate category called "GRATUITIES." More importantly, appellant has not provided the details of any individual transaction that it claims is included in each of the two sales journal categories at issue; such information could be used to verify whether some transactions are in fact included in both categories. Also, appellant has not otherwise shown that any portion of the $398,310 amount represents voluntary nontaxable tips paid to its employees. Thus, OTA concludes that appellant's third argument also lacks merit.

Because appellant has not provided any documentation or other evidence from which a more accurate determination could be made, OTA concludes that appellant has failed to overcome the presumption that CDTFA's determination is correct or otherwise shown that the deficiency amount should be reduced.

HOLDING

The deficiency amount should not be reduced.

DISPOSITION

CDTFA's action in denying appellant's petition is sustained.

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

We concur:

DocuSigned by:
Sheriene Anne Ridenour
67F043D83EF547C...
Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:
0CC6C6ACCC6A44D...
Teresa A. Stanley
Administrative Law Judge

Date Issued: 2/13/2024