OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **WINDY RIDGE, INC.,** **dba Oak Mountain Winery**	OTA Case No. 22029734 CDTFA Case ID 2-022-053

OPINION

Representing the Parties:

For Appellant:	Robert Rosenstein, Attorney Paul Evenson, Attorney
For Respondent:	Nalan Samarawickrema, Hearing Representative Christopher Brooks, Attorney Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Windy Ridge Inc. (appellant) appeals a Decision and Supplemental Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] partially denying appellant's petition for redetermination of a Notice of Determination (NOD) dated January 15, 2020. The NOD is for tax of $118,929, plus applicable interest, and a negligence penalty of $11,892.86 for the period January 1, 2016, through September 30, 2019 (audit period).[2] In the Supplemental Decision, CDTFA reduced the tax from $118,929 to $117,460 and the penalty from $11,892.86 to $11,746.

Office of Tax Appeals (OTA) Administrative Law Judges Suzanne B. Brown, Sheriene Anne Ridenour, and Huy "Mike" Le held an electronic oral hearing for this matter on

[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 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] 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 April 30, 2020. (R&TC, §§ 6487(a), 6488.)

August 17, 2023. At the conclusion of the hearing, the record was held open to allow appellant's submission of a claim for refund and CDTFA's response. On September 28, 2023, the record was closed and this matter was submitted for an Opinion.

ISSUES

1. Whether further adjustments are warranted to the audited understatements of reported taxable sales of the winery and restaurant.
2. Whether adjustments are warranted to the audited amount of unreported taxable mandatory gratuities.
3. Whether adjustments are warranted to the unreported taxable sale of a business asset.
4. Whether the negligence penalty was properly imposed.

FACTUAL FINDINGS

1. Appellant has operated a winery in Temecula, California, since June 2002, selling wine and wine club memberships, as well as food products, such as avocado oils and balsamic vinegars, the sales of which are exempt from sales tax. Appellant offers wine tasting and is a location for weddings and other events. In 2017, appellant opened a restaurant at the winery, Cave Café. Appellant offered discounts on Groupon for both the winery and the restaurant. Appellant was audited previously, for the period July 1, 2012, through June 30, 2015.
2. For the audit period, appellant reported total sales of $6,860,083, claimed nontaxable sales of $510,930,[3] and reported taxable sales of $6,349,153.
3. Throughout the audit period, appellant utilized various point-of-sale (POS) systems to record sales for the winery and the restaurant.
4. For audit, appellant provided federal income tax returns (FITRs) for 2016, 2017, and 2018; bank statements for the audit period; Sales Tax Reports from the Xudle POS system for 2017; MicroWorks POS electronic data for the period January 1, 2017, through September 30, 2019; MicroWorks Sales summary Reports for 2017 and 2018;

[3] Appellant claimed interstate sales of $6,811; exempt sales of food totaling $268,822; nontaxable sales for resale totaling $22,402; sales tax included of $204,893; and other deductions of $8,002.

Micros POS System Tax Reports for the second quarter 2018 (2Q18); and Harbor Touch POS Sales Reports for 2018 and for the first three quarters of 2019.

5. In its preliminary analysis, CDTFA found that the gross receipts reported on appellant's FITRs substantially reconciled with the total sales reported on appellant's sales and use tax returns (SUTRs) for 2017. However, CDTFA noted that the amounts reported on appellant's FITRs for 2016 and 2018 exceeded the amounts reported on its SUTRs by $419,332 and $658,061, respectively. CDTFA concluded that further investigation was warranted.

6. For 2016 (before the restaurant was operating), CDTFA compared the sales recorded on the Xudle POS system to reported sales to establish an understatement of $297,618.

7. For 2017, CDTFA found that the MicroWorks POS reports included sales for the winery only. Appellant had used Micros POS for the restaurant during 2017, but by the time of the audit, it no longer had access to that POS data.

8. To establish the restaurant sales for 2017, CDTFA used a bank deposit reconciliation. For the period January 1, 2017, through September 30, 2019, CDTFA scheduled bank deposits and reduced the total deposits by the amounts for which appellant provided documentation that the deposited funds did not represent sales. Those deposits from sources other than sales were from the following items: purchase returns; property sold church rentals; transfers from appellant's family trust, a savings account, and a credit line; and returns of bill payments. CDTFA identified the remainder as bank deposits related to sales.

9. For 2017, CDTFA scheduled the bank deposits related to sales, which included tax reimbursement and tips. It deducted recorded out-of-state sales and exempt sales of food products to establish audited taxable sales by both the winery and restaurant, with tax reimbursement and tips included. CDTFA then deducted the sales by the winery, which had been recorded on the MicroWorks POS; the balance represented audited restaurant sales, with sales tax reimbursement and tips included. Next, CDTFA deducted the audited amount of tips included, computed at 11.95 percent (the percentage CDTFA calculated using appellant's records on the Harbor Touch POS system for the period April 1, 2018, through July 31, 2019). It then deducted the amount of sales tax included to establish audited taxable restaurant sales of $288,489. CDTFA added that figure to

recorded taxable winery sales of $1,601,327 to establish audited taxable sales for 2017 of $1,889,816. That figure exceeded reported taxable sales for 2017 of $1,566,085 by $323,731.

10. For 3Q18 and 4Q18, appellant's Harbor Touch POS system had recorded taxable sales of $90,531 for 3Q18 (sales of $158,971 less discounts and the full retail value of Groupon sales[4] of $68,440) and $103,336 for 4Q18 (sales of $203,932 less discounts and the full retail value of Groupon sales of $100,596). Although appellant confirmed that it offered Groupon deals during 2018, it did not have records of the amounts of redeemed Groupon deal-of-the-day instruments (DDIs). Accordingly, CDTFA estimated the amounts of redeemed Groupon DDIs, using the quarterly average of redeemed Groupon DDIs recorded for the first three quarters of 2019, $39,427 per quarter. CDTFA thus computed restaurant sales of $129,958 ($90,531 + $39,427) for 3Q18 and $142,763 ($103,336 + $39,427) for 4Q18.

11. CDTFA added the recorded winery sales of $899,569 for 3Q18 and 4Q18 to audited restaurant sales (recorded amounts plus estimated amounts of redeemed Groupon DDIs) of $272,721 ($129,958 + $142,763) to establish audited taxable sales of $1,172,290 for the two quarters, which exceeded reported taxable sales for those quarters by $270,794.

12. For periods prior to early June 2018, appellant used the Micros POS system to record restaurant sales, and its records from that POS system were severely limited. Appellant recorded no restaurant sales for 1Q18, and only $44,695 in restaurant sales for 2Q18. CDTFA concluded that the incomplete records were not reliable. To establish audited restaurant sales for 1Q18 and 2Q18, CDTFA used audited average quarterly sales for 3Q18 and 4Q18 of $136,361 ($272,721 ÷ 2). For those two quarters, CDTFA added recorded taxable winery sales of $866,283 and audited restaurant sales of $272,721 to compute audited taxable sales of $1,139,004, which exceeded reported taxable sales of $776,303 by $362,701.

[4] In order to record the discounts associated with the deal-of-the-day instruments (DDIs) (since the products sold represented a higher retail value than appellant received through the DDI), appellant's routine procedure was to record the sale at retail and then reduce recorded sales by the retail value of the item sold through Groupon. While appellant apparently intended to add back the amount for the redeemed DDI, those amounts did not get recorded in appellant's restaurant sales.

13. Regarding the first three quarters of 2019, appellant provided evidence of taxable restaurant sales of $501,933. That evidence included appellant's records of restaurant sales of $666,461, discounts and full retail value of Groupon sales of $273,727, sales tax collected of $9,042 for Groupon transactions, and sale of gift cards of $40, which represented a total of $383,652 restaurant sales not related to Groupon ($666,461 - $273,727 - $9,042 - $40). Although the amounts of redeemed DDIs were not shown in appellant's records, appellant provided the numbers of deals and the amounts. CDTFA used that information, along with the recorded sales tax related to Groupon sales, to compute redeemed Groupon DDIs of $118,281. Thus, CDTFA computed restaurant sales of $501,933 ($383,652 + $118,281) for those quarters.
14. For the first three quarters of 2019, CDTFA added recorded taxable winery sales of $1,594,086 to audited restaurant sales of $501,933, to compute taxable sales of $2,096,019. CDTFA compared that figure to reported sales of $1,864,468 to establish an understatement of $231,551 for those three quarters.
15. On the Harbor Touch POS records, CDTFA noted that appellant recorded "auto gratuities" totaling $30,854 for the period June 1, 2018, through September 30, 2019. CDTFA concluded that the "auto gratuities" were taxable mandatory gratuities which had not been reported on appellant's SUTRs. CDTFA noted that it did not have evidence of mandatory gratuities charged before June 2018.
16. On appellant's FITR for 2018, CDTFA noted a sale of a business asset (a pump) in February 2018. Appellant did not provide evidence that it reported sales tax for the sale. Accordingly, CDTFA established the selling price of $7,694 as an unreported taxable sale.
17. In total, CDTFA established an understatement of $1,524,943, consisting of unreported taxable sales totaling $1,486,395 ($297,618 for the year 2016; $323,731 for 2017; $362,701 for 1Q18 and 2Q18; $270,794 for 3Q18 and 4Q18; and $231,551 for the first three quarters of 2019); unreported taxable mandatory gratuities of $30,854; and $7,694 for an unreported taxable sale of a business asset). CDTFA concluded that the understatement was the result of negligence.
18. On January 16, 2020, CDTFA issued appellant the NOD for tax of $118,929, plus applicable interest, and a negligence penalty of $11,892.86.

19. On February 14, 2020, appellant filed a petition for redetermination.

20. On June 9, 2021, CDTFA issued a Decision denying the petition.

21. Thereafter, appellant filed with CDTFA a request for reconsideration (RFR). With the RFR, appellant provided System Balance Reports for the restaurant for 1Q18 and for the period April 1, 2018, through June 25, 2018. Using those reports, CDTFA conducted a reaudit and established audited restaurant sales of $113,646 for 1Q18 and $140,128 for 2Q18 (including estimated redeemed Groupon DDIs of $39,427 for each quarter). In comparison to the estimated sales of $136,361 for each quarter, the revised sales figures represented a decrease of $22,715 for 1Q18 and an increase of $3,767 for 2Q18, and an overall decrease of $18,948[5] in audited taxable sales.

22. As part of its response to appellant's RFR, CDTFA computed markups using audited restaurant sales and spreadsheets appellant submitted listing its food costs. CDTFA's markup calculations (rounded) were 82 percent for 1Q17, 114 percent for 2Q17, 89 percent for 3Q17, and 163 percent for 4Q17, with an overall markup of 110 percent for the year 2017. CDTFA stated that it would expect a markup of approximately 245 percent for the type of restaurant appellant operates.

23. On August 10, 2021, CDTFA issued a reaudit report stating that the tax had been reduced by $1,469, from $118,929 to $117,460, which reduced the negligence penalty from $11,892.86 to $11,746. In a Supplemental Decision dated January 11, 2022, CDTFA ordered the liability redetermined in accordance with the reaudit report but otherwise denied appellant's RFR.

24. This timely appeal to OTA followed.

DISCUSSION

Issue 1: Whether further adjustments are warranted to the audited understatements of reported taxable sales of the winery and restaurant.

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

[5] CDTFA computed $18,947, which is an immaterial difference.

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).)

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 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 Talavera*, 2020-OTA-022P.) Once CDTFA has met 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*.)

For this case, CDTFA found that appellant's records were incomplete, and the available records were in conflict with one another. Appellant used several different POS systems during the audit period, and the records available from each of the POS systems differed. To the extent possible, CDTFA relied on appellant's records. For instance, audited sales for the year 2016 and the first three quarters of 2019 represent the amounts shown in appellant's records.[6] For the year 2018, CDTFA used appellant's records to establish audited restaurant sales other than sales related to Groupon.[7] However, for 2018, appellant did not provide records of the redeemed Groupon DDIs. Therefore, CDTFA estimated those amounts based on recorded figures for 2019 and added them to appellant's recorded sales other than Groupon. Since audited sales are based primarily on appellant's sales records for the audit period other than the year 2017 (for which CDTFA utilized a bank deposit analysis), CDTFA has established that its determination is reasonable and rational. Therefore, appellant has the burden to establish that adjustments are warranted.

[6] Although appellant did not record the Groupon-related sales in its restaurant sales, the information CDTFA used to compute the amounts of redeemed Groupon DDIs was gathered from subsidiary records appellant provided to CDTFA. Accordingly, the entire amount for 2019 effectively represents appellant's recorded sales.

[7] To establish sales other than sales related to Groupon, for 3Q18 and 4Q18, CDTFA used appellant's Harbor Touch POS records. In the reaudit, CDTFA used appellant's System Balance Reports for 1Q18 and 2Q18.

Appellant argues that CDTFA's determinations of the winery and restaurant's sales are inaccurate, as discussed below.

Computation of restaurant sales (other than Groupon sales)

Appellant argues that CDTFA's computation of restaurant sales is not accurate or reasonable. Appellant indicates that a more accurate method involves computing the quantity of food purchased, making adjustments such as spoilage, and then adding a "standard markup." Appellant points to its calculations of its costs, as reflected on appellant's spreadsheets showing amounts of food purchases from each vendor.

With respect to audited sales for periods other than 2017, the evidence establishes that audited amounts are based solely on appellant's records for 2016 and the first three quarters of 2019. For 2018, CDTFA established restaurant sales (other than Groupon sales) using appellant's System Balance Reports for the first two quarters of 2018 and appellant's Harbor Touch POS records for the last two quarters of 2018. Thus, for 2018, audited restaurant sales represent the total of appellant's recorded restaurant sales other than Groupon and estimated amounts of redeemed Groupon DDIs, which are addressed separately below.

Appellant has not established that its *recorded* sales for the year 2016 and for the first three quarters of 2019 were overstated. Similarly, for 2018, appellant has not established that its recorded sales (other than Groupon-related sales) were overstated. Accordingly, since appellant's records are the source of audited amounts for 2016, the first three quarters of 2019, and for non-Groupon sales for 2018, there is no basis to consider adjustments to those audited sales.

Regarding 2017, appellant argues that for the majority of that year, the restaurant was not fully operational and was a fledgling business with few customers. Appellant asserts that the audited sales are estimates and that CDTFA is improperly imputing restaurant sales for the first quarter 2017 through the first quarter 2018 using an average for two quarters from a year-and-a-half after opening.

However, this characterization of CDTFA's audit approach is not accurate. For 2017, CDTFA did not utilize average sales from other quarters to establish audited sales. Since CDTFA did not utilize averages from quarters after the restaurant was established, appellant's argument that the restaurant sales were lower in early 2017 is not germane to the analysis of the audited understatement for 2017.

For 2017, CDTFA conducted a detailed bank deposit analysis in which it deducted winery sales from known bank deposits, net of funds not related to sales, and regarded the balance as restaurant sales. CDTFA first scheduled appellant's total deposits and deducted deposits that represented funds from sources other than sales of tangible personal property (i.e., transfers from a savings account, a family trust, and a credit line; purchase returns; refunds related to bill payments; sales of property, and church rentals). The remainder represented bank deposits related to sales of tangible personal property, as well as sales tax reimbursement and tips that were deposited in the bank.

To establish the restaurant sales, including tax reimbursement and tips, CDTFA made further reductions to the bank deposits, deducting recorded nontaxable winery sales; taxable winery sales, net of tax; sales tax on winery sales; and tips recorded for the winery. The remaining bank deposits represented audited restaurant sales including sales tax reimbursement and tips.

CDTFA then reduced the audited restaurant sales, including tax and tips, by an estimated amount of tips, computed at 11.95 percent,[8] and by the amount of sales tax included. The balance represented audited restaurant sales, net of tax and tip. CDTFA computed restaurant sales, net of tax and tip, of $57,817 for 1Q17; $75,505 for 2Q17; $74,532 for 3Q17; and $80,635 for 4Q17.

Appellant argues that additional adjustments to the bank deposits are warranted for deposits not related to taxable sales. As support, appellant provided a list of dates, names, and amounts, with a brief description of each entry. Appellant asserts that the listed amounts are deposits of funds that do not represent sales of tangible personal property. Appellant states that all the listed amounts represent funds from sources other than sales.

To explain one purported deposit, identified as "Cause Fur Paws," appellant states that its account was used as a "pass through for a donation that was received for the charity, Cause Fur Paws." In other words, appellant asserts that someone provided it money for Cause Fur Paws, which appellant deposited in its account to be donated to the organization. As evidence, appellant provided its check dated August 24, 2021, to Cause Fur Paws, for $2,819. However, there is no reason to conclude, based on the available evidence, that there were separate deposits

[8] CDTFA used the Harbor Touch POS records for the period April 1, 2018, through September 30, 2019, to compute that credit card tips represented 11.95 percent of gross receipts.

in appellant's bank accounts, from sources other than sales, that were used for the donation. Moreover, relevant to appellant's 2017 bank deposits, the listed entry is $1,200 on October 19, 2017, but the evidence does not show such a deposit in appellant's bank account on or about that date.

Regarding another category of purported deposits identified as "Farm Management," appellant states that it provided services to various individuals and wineries for management of vineyards, maintenance of the vines, and for certain individuals, the actual production and bottling of wine. The list of deposits that appellant provided includes deposits from Plant's Choice of $10,971 on May 24, 2017; $6,600 on August 8, 2017; and $35,915 on October 2, 2017, for appellant's farm management services. However, appellant has not produced any corresponding invoices from 2017.[9] Instead, appellant provided two invoices dated November 9, 2019, which appellant's vice-president testified that appellant issued to Plant's Choice for farm management services. These invoices from 2019 are not sufficient to establish that appellant made deposits in 2017 for nontaxable services. Moreover, it is not apparent, nor has appellant identified, how those entries correlate to any bank deposits shown on appellant's bank statements for those months. For all of these reasons, appellant has not established that additional deposits in 2017 were for nontaxable sales of services.

In addition, appellant lists various other items and provides explanations. For example, appellant states that it provided storage services for wine. However, appellant has not provided evidence, such as invoices, to document those transactions nor has appellant shown how they correlate to any deposits listed on appellant's 2017 bank statements. Unsupported assertions, without documentation, are not sufficient to satisfy appellant's burden of proof. (*Appeal of Talavera*, *supra*.)

Accordingly, OTA finds that CDTFA made adjustments to bank deposits for all documented deposits of funds from sources other than taxable sales. Appellant has not established that there were additional deposits for which adjustments to the bank deposit analysis are warranted.

[9] In a letter dated August 4, 2022, OTA requested that appellant provide further explanation and detailed records to support the list of dates, names, and amounts that appellant provided to show amounts deposited in the bank account in 2017 that do not relate to sales of tangible personal property.

Additionally, regarding appellant's contention that its sales are more accurately determined by adding a markup to appellant's calculations of its costs, OTA notes that appellant has not conducted a shelf test[10] to establish its actual markup. Moreover, in response to appellant's contention, CDTFA computed markups using audited restaurant sales (based on a bank deposit analysis) and the monthly vendor food costs from appellant's spreadsheet. The (rounded) markups are 82 percent for 1Q17, 114 percent for 2Q17, 89 percent for 3Q17 and 163 percent for 4Q17, with an overall markup of 110 percent for the year 2017. In a September 10, 2021 memorandum, CDTFA notes that it would expect a markup of approximately 245 percent for the type of restaurant appellant operates. Thus, the markups ranging from 82 percent to 163 percent, mentioned above, offer strong evidence that the audited restaurant sales are not overstated.

In summary, OTA finds that appellant has not shown that there were errors in the bank deposit analysis CDTFA used to establish audited restaurant sales for 2017. Further, appellant has not identified overstatements in its records, which CDTFA used to establish restaurant sales for the remainder of the audit period (other than Groupon sales for 2018, which are addressed below). Consequently, appellant has not met its burden to establish that adjustments are warranted to audited restaurant sales.

Groupon sales for 2018

For 2019, appellant provided information regarding its redeemed Groupon DDIs, from which CDTFA computed taxable Groupon-related sales. CDTFA used the number of coupons redeemed and the consideration for each deal to compute taxable sales related to Groupon of $37,653 for 1Q19 and $39,776 for 2Q19. For 3Q19, CDTFA used the sales tax collected on Groupon transactions, divided by the tax rate, to compute taxable sales related to Groupon of $40,852.[11] In other words, CDTFA computed the Groupon sales for 2019 based on other information related to Groupon transactions in the records. Appellant has not established or

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

[11] CDTFA noted that the taxable sales computed for 3Q19, using the number of coupons redeemed and the consideration for each coupon, was $17,261. However, CDTFA concluded that figure was not reliable because appellant had collected sales tax reimbursement of $3,166 related to redeemed Groupon coupons (which is significantly greater than the approximate 7.75 percent tax on $17,261 of $1,338). Accordingly, CDTFA used the amount of sales tax collected to compute the taxable sales related to Groupon for 3Q19.

argued that the audited taxable sales related to Groupon for those three quarters are incorrect. Further, appellant has not argued that the recorded sales related to Groupon in 2019 are included in recorded restaurant sales.

Specifically, for 2019, appellant recorded "Gross Total Sales, Restaurant, extax" ($207,137 for 1Q19; $224,352 for 2Q19; and $234,972 for 3Q19); and "Discounts and Full Retail Value of the Groupon Deal" ($85,218 for 1Q19; $91,579 for 2Q19; and $96,930 for 3Q19) in its Harbor Touch POS system. CDTFA then computed the "Taxable Groupon Redeemed" ($37,653 for 1Q19; $39,776 for 2Q19; and $40,852 for 3Q19) from appellant's subsidiary records for Groupon transactions. Thus, OTA finds that for 2019, appellant did not include Groupon-related sales in its recorded "Gross Total Sales, Restaurant."

It is undisputed that appellant accepted Groupon DDIs during 2018. For 3Q18 and 4Q18, when appellant utilized the Harbor Touch POS System, appellant recorded "Gross Total Sales, Restaurant, extax" of $158,971 for 3Q18 and $203,932 for 4Q18. Appellant had also recorded "Discounts and Full Retail Value of Groupon Deal" of $68,440 for 3Q18 and $100,596 for 4Q18. However, appellant did not provide records from which CDTFA could compute the amounts of "Taxable Groupon Redeemed" for 2018 as it had for the first three quarters of 2019.

CDTFA concluded that appellant's recorded restaurant sales did not include its taxable sales related to Groupon. To establish audited taxable sales related to Groupon, CDTFA used the average quarterly amount for 2019 of $39,427[12] for 3Q18 and 4Q18. Also, when appellant provided its System Balance Reports for 1Q18 and 2Q18 for the reaudit, CDTFA used the amounts recorded on those reports as sales other than Groupon and added $39,427 per quarter for Groupon-related sales.

Appellant argues that CDTFA's use of $362,701 for the first two quarters of 2018 is arbitrary. CDTFA revised the audited amount of restaurant sales for the first two quarters of 2018 in the reaudit, and the total for those two quarters is not $362,701. However, OTA infers from context that appellant is actually disputing CDTFA's estimated amount of taxable sales related to Groupon of $39,427, which was used for each quarter in 2018.

In its argument regarding Groupon sales in 2018, appellant explains that Groupon transactions are retail sales only when the Groupon DDI is redeemed. As evidence, appellant

[12] $37,653 + $39,776 + $40,852 = $118,281. $118,281 ÷ 3 = $39,427

provided documents that illustrate the types of Groupon deals it has offered. Appellant's explanation is not disputed by CDTFA. Both parties agree that taxable sales related to Groupon represent only redeemed DDIs.

Appellant asserts that Groupon sales would be included in computing restaurant sales. On that basis, appellant argues that CDTFA is duplicating taxable sales by separately establishing Groupon sales.

As established above, there is no dispute that appellant recorded restaurant sales separately from redeemed Groupon DDIs in 2019, a period for which appellant provided more detailed information regarding the redeemed DDIs. Appellant has not documented or established why Groupon-related sales would have been included in recorded restaurant sales for 2018, while it is clear that they were not included in recorded restaurant sales for 2019. Therefore, the available evidence does not support appellant's argument that audited taxable sales duplicate the redeemed Groupon DDIs for 2018.

However, with respect to the audited amounts of redeemed Groupon DDIs, appellant has explained that, when appellant's staff redeemed a Groupon DDI, they first rang the retail sale (at full value) on the cash register, to include the sale under "gross sales," then deducted the full amount, recorded as a discount. Appellant's apparent intention was to record the retail sale of the item related to Groupon, deduct the full retail amount, and then record the amount the customer had paid for the DDI.[13] In that way, appellant would have a record of the amounts of discount related to Groupon. As noted previously, though, appellant did not record the amounts of redeemed Groupon DDIs or report those amounts on its SUTRs.

To estimate the amounts of redeemed DDIs for 2018, CDTFA used the average amount for 2019 since appellant had provided information from which CDTFA was able to compute the taxable amounts of redeemed DDIs. A review of the available data indicates that the average quarterly amount may not be representative of the redeemed DDIs for all quarters of 2018. Specifically, the "Discounts and Full Retail Value of the Groupon Deal" were $68,440 for 3Q18 and $100,596 for 4Q18. In comparison, those discount amounts were $85,218 for 1Q19; $91,579 for 2Q19; and $96,930 for 3Q19. For those respective quarters, the audited amounts of

[13] For instance, if the Groupon DDI authorized the customer to purchase a menu item that regularly sold for $50, and the customer paid $25 for the DDI, appellant would record a sale of $50, a discount of $50, and a sale of $25 (the redeemed DDI).

redeemed DDIs were $37,653, $39,776, and $40,852. Thus, the ratio of redeemed DDIs to "discounts and full retail value of the Groupon deal" were 44 percent ($37,653 ÷ $85,218), 43 percent ($39,776 ÷ $91,579), and 42 percent ($40,852 ÷ $96,930), for 1Q19, 2Q19, and 3Q19, respectively. For the three quarters combined, the percentage is 43 percent. The similarity of those percentages indicates that the relationship between redeemed DDIs and the discounts[14] is reasonably consistent.

Accordingly, rather than utilizing the average quarterly amount of redeemed DDIs for 2019 to establish the amounts of redeemed DDIs for 3Q18 and 4Q18, OTA finds it is more accurate to apply 43 percent to the recorded amounts of "discounts and full retail value of the Groupon deal" for those two quarters, $68,440 and $100,596, respectively. The redeemed Groupon DDIs computed in this manner are $29,429 for 3Q18 and $43,256 for 4Q18, which represent a decrease of $9,998 and an increase of $3,829, respectively, when compared to the $39,427 estimated by CDTFA.

For the first two quarters of 2018, appellant provided no records whatsoever regarding its Groupon-related sales, neither the value of the redeemed DDIs nor the retail value of the Groupon deals. In the absence of any records, OTA finds that the Groupon-related sales for each of the first two quarters of 2018 should be reduced by $3,085, from $39,427 to $36,342, the average of the audited amounts for the last two quarters of 2018.[15] Thus, OTA finds that the audited amount of Groupon-related sales for the year 2018 should be reduced by $12,339 (reductions of $3,085, $3,085, and $9,998 for the first three quarters of the year, respectively, and an increase of $3,829 for 4Q18).

Issue 2: Whether adjustments are warranted to the audited amount of unreported taxable mandatory gratuities.

As noted previously, California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sales of tangible personal property in this state. (R&TC, § 6051.) "Gross receipts" means the total amount of the sale price, including any services that

[14] While the title of the recorded discounts account (discounts and full retail value of the Groupon deal) indicates that there may be discounts other than the full value of Groupon transactions, no other discounts are discussed in the record. Thus, for purposes of this computation, it is reasonable to utilize the consistent percentage of 43 percent.

[15] $29,429 + $43,256 = $72,685. $72,685 ÷ 2 = $36,342.

are part of the sale. (R&TC, § 6012(b)(1).) A "sale" includes the furnishing, preparing, or serving for a consideration of food, meals, or drinks. (R&TC, § 6006(d).) California Code of Regulations, title 18, section 1603(h) applies to restaurants and governs the application of tax to tips, gratuities, and service charges for transactions occurring on and after January 1, 2015.

An optional payment designated as a tip, gratuity, or service charge is not subject to tax. (Cal. Code Regs., tit. 18, § 1603(h).) 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. (*Ibid.*) A payment of a tip, gratuity, or service charge is optional if a restaurant check is presented to the customer with the "tip" area left blank, even if the check shows tips computed at various percentages as options. (Cal. Code Regs., tit. 18, § 1603(h)(1).)

An amount is considered "automatically added" when the retailer adds the tip to the bill without first conferring with the customer after service of the meal. (Cal. Code Regs., tit. 18, § 1603(h)(3)(B).) Nonetheless, any amount added as a tip by the retailer to the bill or invoice presented to the customer is presumed to be automatically added and mandatory. (*Ibid.*) A statement on the bill or invoice that the amount added by the retailer is a "suggested tip," "optional gratuity," or that "the amount may be increased, decreased, or removed" by the customer does not change the mandatory nature of the charge. (Cal. Code Regs., tit. 18, § 1603(h)(3)(C).) This presumption may be controverted by documentary evidence showing that the customer specifically requested and authorized the gratuity be added to the amount billed. (*Ibid.*)

For this case, the records in the Harbor Touch POS system included $30,854 recorded as "auto gratuities." Because the term "auto gratuities" routinely is used to represent tips that are automatically added to customers' bills, and are thus mandatory, CDTFA concluded that the total amount of $30,854 represented taxable mandatory gratuities.

Appellant argues that the recorded "Auto Gratuity" amounts in its POS records were all nontaxable optional gratuities. Appellant states that the POS system erred in recording these tips in the "auto gratuity" category. Appellant states further that this issue has been corrected and that its POS system no longer mis-categorizes optional tips as automatic gratuities. As evidence that its tips were optional, appellant provided an affidavit and testimony from V. Andrews, appellant's vice-president, and copies of two restaurant receipts where the customer wrote in the

tip amount; in the affidavit, appellant's vice-president declared that "all gratuity has been listed as mandatory gratuity" in appellant's POS system.

However, appellant's POS reports, as part of the audit workpapers, show that appellant recorded both "auto gratuity" and optional tips. Thus, appellant's POS records clearly show that the POS system did not record all tips as auto gratuities. Rather, the POS records include separate amounts of "auto gratuities" and "tips." With regard to appellant's restaurant receipts showing that the customer wrote in the tip amount, these documents demonstrate only that appellant did make sales wherein tips were optional; they do not establish that all tips were optional. With respect to V. Andrews' affidavit and testimony, she states that the purportedly erroneous recording of tips as "auto gratuities" was a POS issue that has been resolved. However, in response to OTA's request for documentation of discussions with the POS provider, appellant responded that no such documentation is available.

The available evidence shows that appellant's POS system separately recorded auto gratuities and other tips. Appellant has not established that the amounts of auto gratuities represent optional tips that were erroneously recorded as mandatory gratuities automatically added to customers' bills. Thus, appellant has not established that any adjustments are warranted to the audited amount of mandatory gratuities subject to tax.

Issue 3: Whether adjustments are warranted to the unreported taxable sale of a business asset.

Tax applies to all retail sales of tangible personal property, including capital assets held or used by the seller in the course of an activity for which a seller's permit is required. (Cal. Code Regs., tit. 18, § 1595(a)(1).)

In its review of appellant's 2018 FITR, CDTFA noted that appellant reported a sale of a pump on February 25, 2018, on Form 4797 (Sales of Business Property). Appellant did not provide evidence that it also reported sales tax with respect to that sale for $7,694. While appellant states that it disputes the entire audit liability, it has provided no evidence or argument to establish that this sale of business property was exempt or nontaxable. Therefore, OTA finds that no adjustment is warranted to the unreported taxable sale of a business asset.

Issue 4: Whether the negligence penalty was properly imposed.

R&TC section 6484 provides that if any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the law or authorized rules

and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto.

Taxpayers are required to maintain and make available for examination on request by CDTFA, or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of the SUTRs. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: (a) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (b) bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and (c) schedules or working papers used in connection with the preparation of the tax returns. (Cal Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and keep complete and accurate records, including all bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account, will be considered evidence of negligence and may result in the imposition of penalties. (Cal Code Regs., tit. 18, § 1698(k).)

Generally, a penalty for negligence or intentional disregard should not be added to determinations associated with the first audit of a taxpayer. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A); also see *Independent Iron Works, Inc. v. State Bd. Of Equalization* (1959) 167 Cal App.2d 318, 321-324.) However, a negligence penalty is generally justified where errors are continued from one audit to the next. (*Independent Iron Works, Inc. v. State Board of Equalization, supra*.)

CDTFA imposed a negligence penalty in this case because appellant did not provide complete and adequate records, and appellant had substantially understated its reported taxable sales. CDTFA also stated that appellant had been audited previously and that it had made similar errors in both audit periods.

Appellant argues that it has not improperly accounted for its sales in any portion of the audit period. It asserts that, if there were errors, they are the result of circumstances beyond its control and its reliance on vendors' products and advice.

As addressed above, CDTFA used appellant's records to establish audited sales for 2016 and for the first three quarters of 2019. For those periods, the entire understatement of $529,169 ($297,618 for 2016 and $231,551 for the first three quarters of 2019) represents recorded sales that were not reported. For 2018, the audited understatement is $614,548 ($343,754 for 1Q18

and 2Q18 and $270,794 for 3Q18 and 4Q18). The only portion of that understatement that is not based on appellant's records is the audited amount of sales related to Groupon of $157,708 ($39,427 x 4),[16] which was estimated. Thus, of the total understatement of $1,505,996 established in the reaudit, $986,009 ($529,169 for 2016 and the first three quarters of 2019 + $614,548 for 2018 - $157,708 estimated sales related to Groupon) represents taxable sales shown in appellant's own records that were not reported on its SUTRs.

Any retailer, regardless of its level of experience, should recognize that all recorded taxable sales must be reported to CDTFA. Appellant consistently failed to report significant amounts of sales that were reflected in its records. Moreover, appellant had been audited previously, and thus had experience with recording and reporting requirements. In light of all circumstances, OTA finds that the evidence supports a finding that the understatement was the result of negligence, and the penalty was properly applied.

[16] Although this Opinion recommends an adjustment to the audited sales related to Groupon, the $39,427 is used here merely to calculate the recorded restaurant sales, net of Groupon-related sales.

HOLDINGS

1. The audited amounts of Groupon-related sales for 2018 should be reduced by $12,339. No further adjustments are warranted to the audited understatements of reported taxable sales of the winery and restaurant.
2. No adjustments are warranted to the audited amount of unreported taxable mandatory gratuities.
3. No adjustments are warranted to the unreported taxable sale of a business asset.
4. The understatement was the result of negligence.

DISPOSITION

In addition to CDTFA's reductions pursuant to the Supplemental Decision, appellant is entitled to a reduction to the audited amount of Groupon-related sales for the year 2018 by $12,339. Otherwise, CDTFA's actions are sustained.

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

We concur:

DocuSigned by:
Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:
Huy "Mike" Le
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Huy "Mike" Le
Administrative Law Judge

Date Issued: 12/20/2023