OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **ALTADENA ALE & WINE, INC.,** **dba Altadena Ale House**	OTA Case No. 21037347 CDTFA Case ID 249-004

OPINION

Representing the Parties:

For Appellant:	Gail Casburn, Secretary Tami Robinson, CPA
For Respondent:	Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Craig Okihara, Business Taxes Specialist III

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Altadena Ale & Wine, Inc. dba Altadena Ale House (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] on appellant's petition for redetermination of a Notice of Determination (NOD) dated June 8, 2017.[2] This NOD is for $11,960.64 in tax, plus applicable interest, for the period January 1, 2012, through June 30, 2014 (liability period).

Pursuant to the Decision, CDTFA performed a reaudit (as explained below) which reduced the total taxable measure from $135,005 to $119,793 for the liability period, which will result in reductions to the determined tax from $11,960.64 to $10,607 for the liability period.

[1] Sales 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" refers to BOE.

[2] CDTFA issued two NODs covering the audit period of July 1, 2011, through June 30, 2014. CDTFA issued the first NOD on October 27, 2014, for the period July 1, 2011, through December 31, 2011. CDTFA issued the second NOD on June 8, 2017, for the remaining period January 1, 2012, through June 30, 2014. As explained below, only the second NOD is on appeal here.

Appellant waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record.[3]

ISSUES

1. Whether a further reduction to the measure of unreported taxable sales is warranted.
2. Whether a reduction to the measure of self-consumed taxable merchandise is warranted.

FACTUAL FINDINGS

1. Appellant is a corporation that operated a bar selling wine and beer in Altadena, California. Appellant also sold cigarettes and some food items, such as pizza, cheese and bread plates, and peanuts. Appellant's seller's permit was opened with an effective start date of April 1, 2011. For the period July 1, 2011, through June 30, 2014 (audit period), appellant reported on its sales and use tax returns (SUTRs) total sales of $850,210, claiming deductions of $59,067 for sales tax reimbursement included in reported total sales, and $34,652 for "other" (for voluntary tips included in reported total sales), resulting in reported taxable sales of $756,491. Appellant stated that total sales were reported based on bank deposits, and that it backed-out sales tax reimbursement and 18 percent for estimated voluntary tips.
2. CDTFA issued two NODs covering the audit period. CDTFA issued the first NOD to appellant prior to completion of the audit because appellant did not return a waiver to extend the statute of limitations for issuance of an NOD. The first NOD is for a deficiency measure based on unreported taxable sales for the period July 1, 2011, through December 31, 2011; CDTFA issued this NOD on October 27, 2014, for tax of $11,823.71, plus applicable interest, and a negligence penalty of $1,182.36.
3. Appellant did not timely pay the first NOD or timely file a petition for redetermination within 30 days from the date of issuance, and therefore the first NOD became final.[4] Consequently, the first NOD (and the period July 1, 2011, through December 31, 2011) are not at issue in the present appeal.

[3] Appellant had initially requested an oral hearing, but subsequently did not respond to OTA's Notice of Oral Hearing. Consequently, appellant waived its right to an oral hearing pursuant to California Code of Regulations, title 18, section 30209(a).

[4] After the first NOD became final, a penalty of $1,182.37 was imposed pursuant to R&TC section 6565 for failure to pay an NOD once it becomes due and payable (finality penalty).

4. CDTFA subsequently completed the audit and a revised audit for the liability period.[5] The revised audit calculated a deficiency measure totaling $135,005 for the liability period: $117,734 for unreported taxable sales and $17,271 for the unreported cost of taxable merchandise self-consumed.[6] The revised audit also deleted the negligence penalty. Based on the revised audit, CDTFA issued the second NOD on June 8, 2017, for tax of $11,960.64 plus applicable interest, for the period January 1, 2012, through June 30, 2014. Appellant filed a timely petition for redetermination protesting the second NOD in its entirety.

5. CDTFA held an appeals conference with appellant, and issued a Decision dated May 11, 2020, ordering a reaudit to incorporate adjustments CDTFA recommended[7] on appeal, but otherwise denying appellant's petition.

6. CDTFA issued a reaudit dated January 25, 2021. The audit work papers, including the reaudit, reflect computations as follows. For audit, appellant provided its federal income tax returns (FITRs) for the second quarter of 2011 (2Q11) through 4Q11, 2012, 2013, and 2014; bank statements for January 2013, through June 2014; QuickBooks purchases summary for 2012; recap of purchases for July 1, 2011, through December 31, 2011, and 2013; and purchase invoices for 4Q14 (after the audit period). Appellant did not provide cash register z-tapes[8] or other source documentation supporting sales for the audit period, nor did it provide merchandise purchase invoices supporting recorded purchases for the audit period. CDTFA found the provided books and records were inadequate for sales and use tax audit purposes.

7. CDTFA compared total sales (excluding sales tax reimbursement) that appellant reported on SUTRs for 2Q11 through 4Q11, 2012, 2013, and 2014 to the corresponding gross

[5] The audit and revised audit cover the entire audit period, but these Factual Findings focus on the liability period, which is the only period at issue in this appeal.

[6] The revised audit also reduced the taxable measure, and thus appellant's liability, for the period covered by the first NOD (July 1, 2011, through December 31, 2011).

[7] CDTFA conceded to using a 64-ounce pour size for draft beer pitchers and correcting the pour size for a line item in the wine shelf test.

[8] 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).

receipts that appellant reported on its FITRs. CDTFA noted differences in each of the years, but considered the differences to be immaterial.

8. CDTFA compared gross receipts reported on the FITRs to the corresponding reported cost of goods sold; using that information, CDTFA computed FITR book markups of 40.54 percent for 2Q11 through 4Q11, 61.15 percent for 2012, 93.49 percent for 2013, 126.94 percent for 2014, and 85.35 percent for the four years combined.[9] Based on its experience in audits of similar businesses in appellant's area, CDTFA expected a markup of at least 150 percent. Because of the low and inconsistent book markups and appellant's failure to provide sales source documentation, CDTFA concluded additional testing would be required to verify reported taxable sales.

9. Using Form 1099-K data,[10] CDTFA compiled credit card sales of $35,173 for 3Q11, $45,731 for 4Q11, $238,440 for 2012, and $285,356 for 2013. CDTFA compared these credit card sales amounts (excluding estimated tips of 18 percent and sales tax reimbursement) to reported taxable sales and computed a credit card sales ratio of 80.71 percent for 3Q11, 81.99 percent for 4Q11, 77.35 percent for 2012, and 80.75 percent for 2013. CDTFA used the Form 1099-K data to estimate unreported taxable sales for the period July 1, 2011, through December 31, 2011, and estimated credit card sales ratio of 35 percent; thus, these credit card sales ratios exceeded the ratio that CDTFA expected based on similar businesses in appellant's area.

10. CDTFA requested that appellant maintain cash register tapes for a two-week test period in January 2015. Thereafter, appellant provided sticky notes with handwritten totals of cash sales, credit card receipts, and credit card sales summaries for January 16, 2015, through January 29, 2015. Because appellant did not provide the requested cash register z-tapes to support the sales, CDTFA concluded that the sales amounts were unreliable.

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

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

Consequently, CDTFA concluded that it could not use the credit card sales ratio method to determine audited sales, and therefore decided to rely on the markup method.

11. Appellant provided purchase invoices for 4Q14, but did not provide a purchase journal for 2014. Based on its experience in audits of similar businesses in appellant's area, CDTFA concluded that a one-month purchase cycle would include all types of merchandise that appellant routinely purchased. CDTFA performed a purchase segregation test[11] using available merchandise purchase invoices for the month of December 2014, which disclosed that beer purchases accounted for 62.32 percent, wine purchases accounted for 11.55 percent, cigarette purchases accounted for 9.24 percent, food purchases accounted for 9.08 percent, and supply purchases accounted for 7.81 percent of appellant's merchandise purchases.

12. CDTFA compared merchandise purchases compiled from QuickBooks purchase summaries for 2012 to purchases reported on the 2012 FITR, noting a minor difference. CDTFA concluded that the FITRs were the best evidence of merchandise purchases. Using the 2012 and 2013 FITRs, CDTFA reduced reported purchases by 9.08 percent for food purchases[12] and 7.81 percent for supply purchases to compute beer, wine, and cigarette purchases. Next, CDTFA excluded self-consumption[13] (5 percent), pilferage (5 percent for draft beer, 5 percent for wine, and 1 percent for cigarettes), and bottled beer breakage (1 percent) to calculate the audited cost of beer, wine, and cigarette purchases totaling $120,077 for 2012 and $118,316 for 2013.

13. To establish audited markups for beer, wine, and cigarettes, CDTFA conducted a shelf test[14] using costs from the December 2014 purchase invoices and selling prices appellant

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

[12] Although sales of food for consumption at the business are taxable, CDTFA considered appellant's food sales to be immaterial and decided, for this audit, not to include food sales in computing audited taxable sales.

[13] CDTFA established a separate audit item measuring $19,238 for the cost of self-consumed taxable merchandise. Self-consumed merchandise is subject to tax on the cost of the merchandise rather than the sale price. Thus, the adjustment for self-consumed merchandise reduces the overall tax liability.

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

noted on those invoices and a Bar Fact Sheet dated May 26, 2015.[15] Based on its discussions with appellant and the information provided on the Bar Fact Sheet, CDTFA concluded that 25 percent of beer and wine sales were at happy-hour prices and 75 percent were at regular prices. Using this information, CDTFA computed shelf-test markups for beer, wine, and cigarettes. Using the beer, wine, and cigarette purchases from the purchase segregation test, CDTFA computed the percentages of beer, wine, and cigarette purchases, and then applied those to the respective shelf-test markups to compute a weighted average markup of 152.89 percent.

14. CDTFA added the weighted average markup of 152.89 percent to the audited cost of beer, wine, and cigarette purchases totaling $120,077 for 2012 and $118,316 for 2013 and computed audited taxable sales of $303,664 for 2012 and $299,210 for 2013. Upon comparison to reported taxable sales of $240,211 for 2012 and $274,766 for 2013, CDTFA calculated unreported taxable sales of $63,453 for 2012 and $24,444 for 2013 and error ratios[16] of 26.42 percent ($63,453 ÷ $240,211) for 2012 and 8.9 percent ($24,444 ÷ $274,766) for 2013.

15. CDTFA applied the 2012 error ratio to taxable sales of $240,211 reported on the SUTRs for 1Q12 through 4Q12, and computed unreported taxable sales of $63,453 for that period. CDTFA applied the 2013 error ratio to taxable sales of $438,852 reported on the SUTRs for 1Q13 through 2Q14, and computed unreported taxable sales of $39,069 for that period.[17] Thus, for the liability period, CDTFA calculated unreported taxable sales of $102,522 ($63,453 + $39,069).

16. CDTFA also established a separate taxable measure for the unreported cost of self-consumed taxable merchandise. CDTFA divided self-consumed merchandise of $13,105 ($6,601 for 2012 + $6,504 for 2013) by taxable sales of $514,977 reported on the SUTRs for 2012 and 2013 combined, and computed a ratio of 2.54 percent. CDTFA applied the ratio to taxable sales of $164,086 reported on the SUTRs for 1Q14 and 2Q14,

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

[16] That is, the "error ratio" is the percentage of unreported taxable sales to reported taxable sales.

[17] Minor differences are the result of rounding.

and computed unreported taxable self-consumption of $4,167 for that period. Thus, for the liability period, CDTFA calculated $17,271 ($13,105 + $4,167)[18] as the unreported cost of self-consumed taxable merchandise.

17. The reaudit reduced the determined taxable measure for the liability period by $15,212, from $135,005 to $119,793 ($102,522 + $17,271). By letter dated February 1, 2021, CDTFA notified appellant of the available options for the next steps in its appeals case. Appellant timely appealed to OTA.

DISCUSSION

Issue 1: Whether a further reduction to the measure of unreported taxable sales is warranted.

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 for consumption on the premises of the retailer 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 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*.)

[18] Minor difference is due to rounding.

Here, appellant failed to provide cash register z-tapes supporting sales during the liability period. The books and records appellant provided for audit were inadequate for sales and use tax audit purposes; thus, CDTFA was unable to verify sales appellant reported on its SUTRs for the liability period using a direct audit method (that is, compiling audited sales directly from appellant's records). CDTFA's preliminary analysis found unacceptably low and inconsistent book markups, which were indications that reported sales may have been understated. OTA finds that it was reasonable for CDTFA to question reported sales and use an indirect audit method to compute appellant's sales. CDTFA used the markup method as the basis for its determination, and the markup method is a recognized and standard accounting procedure. (*Appeal of East Coast Foods, Inc.*, 2023-OTA-289P; *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 612-613.) Thus, CDTFA has met its initial burden to show that its determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to show errors in the audit.

Appellant raises several contentions, including that it never had any unreported sales, that the audit is based on incorrect theories and estimates, and that the markup method is not appropriate. Appellant argues that the audit needs to be "redone based on an income method," and indicates that a reaudit should be conducted using the "ACTUAL data showing the breakdown of Cash and Credit Card sales." (Emphasis in original.) Appellant states that its "total credit card sales approximated 90% of sales."

Regarding CDTFA's reliance on the markup method, there is no requirement that CDTFA must use one audit method over another; OTA notes that CDTFA's audit methodology followed the relevant provisions for a markup audit pursuant to CDTFA's Audit Manual, Chapter 8, Bars and Restaurants.[19] Regarding appellant's contentions about credit card sales data, CDTFA used Form 1099-K data to compute credit card sales ratios of 77.35 percent for 2012 and 80.75 percent for 2013, which were much higher than CDTFA expected.[20] While

[19] CDTFA's Audit Manual is an advisory publication providing direction to CDTFA staff administering the Sales and Use Tax Law and applicable regulations. OTA is not required to follow CDTFA's Audit Manual; however, OTA may look to the Audit Manual for guidance, such as when evaluating the reasonableness of CDTFA's determination. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

[20] In the present appeal, CDTFA states that "during the appeals process, a calculation error was noted which, if corrected, would result in the achieved credit card sales ratio of approximately 61% for 2012 and 74% for 2013," but because this error does not impact the audit findings, CDTFA did not take any further action.

CDTFA sought to conduct a two-week test of sales in January 2015 to verify the credit card sales ratio, appellant failed to provide the requested cash register tapes to support the sales; as a result, CDTFA concluded that the sales amounts from the test were unreliable, and thus it could not determine a reliable credit card sales ratio. Given these circumstances, it was reasonable for CDTFA to disregard that test as a basis for its audit methodology.

Regarding the audited cost of beer, wine, and cigarette purchases, appellant states that the "Purchases" amounts listed on its tax returns were for all types of purchases, which appellant describes as including both "resale purchases and NOT for resale purchases";[21] appellant appears to argue that CDTFA's computation of audited costs did not exclude appellant's purchases of beer, wine, and cigarettes, which appellant sold to customers, from its purchases of supplies. However, the facts do not support appellant's position. Based on an analysis of appellant's December 2014 merchandise purchase invoices, CDTFA reduced reported FITR purchases for supply purchases of 7.81 percent, and excluded food purchases of 9.08 percent. CDTFA also excluded self-consumption (5 percent), pilferage (5 percent for draft beer, 5 percent for wine, and 1 percent for cigarettes), and breakage of bottled beer (1 percent) to calculate the audited cost of beer, wine, and cigarette purchases. Appellant has not provided any documentation supporting amounts greater than CDTFA allowed, nor has appellant identified any errors in CDTFA's computations. Accordingly, appellant's unsupported assertions are not sufficient to meet appellant's burden of proof, and there is no basis to reduce the taxable measure on these grounds.

In summary, OTA finds that CDTFA computed audited taxable sales based on the best available evidence. Appellant has not identified any errors in CDTFA's computation of audited taxable sales or provided new documentation or other evidence in support of its contentions from which a more accurate determination could be made. Consequently, no adjustments are warranted.

Issue 2: Whether a reduction to the measure of unreported self-consumed taxable merchandise is warranted.

While the sale and use of many food products are exempt from tax, alcoholic and carbonated beverages are not included in that exemption. (Cal. Code Regs., tit. 18, §1602(a)(2).)

[21] OTA notes that appellant's use of the term "resale" does not appear to mean non-retail "sales for resale" as used in R&TC section 6007 and California Code of Regulations, title 18, section 1668.

When sales tax does not apply, use tax applies to the storage, use, or other consumption of tangible personal property purchased from any retailer for storage, use, or other consumption in this state, measured by the sales price, unless that use is specifically exempted or excluded by statute. (R&TC, §§ 6201, 6401.) As noted above, when CDTFA has met its initial burden of establishing a reasonable and rational basis for its determination, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted, and unsupported assertions are not sufficient to carry that burden. (*Appeal of Talavera*, *supra*.)

CDTFA allowed self-consumption of 5 percent of beer, wine, and cigarette purchases for 2012 and 2013 ($13,105) and calculated $17,271 as the measure of the unreported cost of self-consumed taxable merchandise for the liability period.

Appellant concedes that it owes use tax on the cost of self-consumed taxable merchandise and charitable contributions of taxable inventory. Appellant states that it made many charitable contributions of taxable inventory and estimates that these did not exceed $3,000 per calendar year. Appellant asserts that the total measure of self-consumed taxable merchandise (which incorporates the alleged charitable contributions) should be $10,500 for the audit period. Thus, for the liability period, appellant concedes to unreported cost of self-consumed taxable merchandise of $8,750 (($10,500 ÷ 12 quarters) × 10 quarters) and the amount remaining in dispute is $8,521 ($17,271 - $8,750). Appellant did not provide any documentation to support its arguments regarding self-consumption.

There is no dispute that appellant owes use tax on the cost of self-consumed taxable merchandise. OTA finds that it was reasonable for CDTFA to estimate that 5 percent of beer, wine, and cigarette purchases were self-consumed, based on CDTFA's experience in auditing similar businesses. Therefore, the burden of proof shifts to appellant to provide evidence to support a different amount of taxable self-consumption.[22] Appellant has not provided any records to substantiate the amount of self-consumption. Appellant's unsupported estimate is not sufficient to support a different amount of taxable self-consumption. (*Appeal of Talavera*, *supra*.)

In addition, appellant argues that its charitable contributions for the 2011 tax year should not be omitted from CDTFA's calculations for the liability period. As discussed above, CDTFA

[22] A reduction to self-consumption would result in an increase in the measure of taxable sales as computed under the markup method.

audited appellant for the period July 1, 2011, through June 30, 2014. However, because appellant did not return a waiver to extend the statute of limitations for issuance of an NOD prior to completion of the audit, CDTFA issued the first NOD to appellant on October 27, 2014, for the period July 1, 2011, through December 31, 2011. Appellant did not timely pay the tax portion of the first NOD or timely file a petition for redetermination within 30 days from the date of issuance, and therefore that NOD became final and is not part of the liability period at issue here.

In light of all of the above, appellant has not met its burden of proof and is not entitled to a reduction of the measure of unreported self-consumption.

HOLDINGS

1. Appellant has not shown that further reduction to the measure of unreported taxable sales is warranted.
2. Appellant has not shown that a reduction to the measure of self-consumed taxable merchandise is warranted.

DISPOSITION

CDTFA's actions of reducing the deficiency measure for the second NOD from $135,005 to $119,793, but otherwise denying the petition, are sustained.

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

We concur:

DocuSigned by:
Lauren Katagihara
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Lauren Katagihara
Administrative Law Judge

DocuSigned by:
DC88A60D8C3E442...
Keith T. Long
Administrative Law Judge

Date Issued: 1/25/2024