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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 221011555
LA BOOM ENTERTAINMENT, INC., dba Leonardo's	CDTFA Case ID: 002-377-522

OPINION

Representing the Parties:

For Appellant: Leonardo Lopez, Owner

For Respondent: Ravinder Sharma, Hearing Representative
Christopher Brooks, Attorney
Jason Parker, Chief of Headquarters Ops.

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, La Boom Entertainment, Inc. dba Leonardo's (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated September 16, 2020. The NOD is for tax of $145,081, plus applicable interest, and a negligence penalty of $14,508.08 for the period October 1, 2016, through September 30, 2019 (audit period).[2]

CDTFA prepared a reaudit and reduced the audited understatement of reported taxable sales by $2,473, from $1,854,547 to $1,852,074, and the unreported taxable costs of self-consumed merchandise by $16, from $8,528 to $8,512. As a result, CDTFA reduced the determined tax from $145,081 to $144,884, and reduced the negligence penalty from $14,508.08 to $14,488.43.

[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.

[2] The NOD was issued timely because, on October 30, 2019, appellant signed a waiver of the otherwise applicable three-year statute of limitations, which extended until October 31, 2020, the time within which CDTFA could issue an NOD for the period October 1, 2016, through June 30, 2017. (See R&TC, §§ 6487(b), 6488.)

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Lauren Katagihara, and Andrew Wong held an oral hearing for this matter in Cerritos, California, on February 14, 2024. At the conclusion of the hearing, the record was closed, and this matter was submitted for an opinion.

ISSUES

1. Whether appellant has shown that an additional reduction to the amount of unreported taxable sales is warranted.
2. Whether the negligence penalty was properly imposed.

FACTUAL FINDINGS

1. Appellant, doing business as Leonardo's, has operated a nightclub with a full bar, entertainment, and a limited menu of Mexican-style food, since April 20, 2000.
2. For the audit period, appellant reported total sales of $614,180 and claimed no deductions, which resulted in reported taxable sales of $614,180.
3. For audit, appellant provided its federal income tax returns (FITRs) for the years 2016 through 2018, a general ledger, an incomplete set of bank statements, and some purchase invoices, credit card merchant statements, and cash register Z-tapes.[3]
4. CDTFA examined purchases recorded in the general ledger and noted that the only "Beer and Liquor" purchases appellant recorded were from Harbor Distributing Company (Harbor), a vendor that primarily sells beer.
5. Based on its examination of appellant's FITRs, CDTFA noted that appellant's reported gross receipts increased from 2016 to 2018, but its reported costs of goods sold decreased during that period. Because CDTFA expected that appellant's costs would increase when its sales increased, CDTFA concluded that the purchases reported on the FITRs were unreliable and possibly understated.
6. In an attempt to obtain information regarding appellant's costs of alcoholic beverages sold, CDTFA surveyed well-known vendors in the area. However, only two vendors, Harbor and Straub, responded to CDTFA's request for information. Appellant also provided some purchase invoices from Restaurant Depot, which showed small amounts

[3] The cash register Z-tape is the portion of a cash register tape that summarizes sales for a specified period of time.

of purchases of liquor in 2017. Using the purchase information provided by Harbor and Straub, and the purchase invoices from Restaurant Depot provided by appellant, CDTFA compiled purchases totaling $17,824 for the fourth quarter of 2016 (4Q16), $73,916 for 2017, and $71,141 for 2018. Because Harbor primarily sells beer, and Straub is a beer distributor, CDTFA determined that nearly all of the purchase records it compiled were only for beer.[4]

7. When it examined reviews of appellant's business on Yelp.com, CDTFA found pictures showing appellant's bar stocked with a variety of name-brand liquors. Based on the photos and videos of the fully stocked bar, CDTFA estimated that appellant's purchases of liquor were equal to its purchases of beer (i.e., liquor-to-beer ratio of 50:50). Accordingly, CDTFA established beer and liquor (alcohol) purchases of $35,969 ($17,984 + $17,984) for 4Q16,[5] $141,244 ($70,622 + $70,622) for 2017, and $142,282 ($71,141 + $71,141) for 2018, totaling $319,495 for the period October 1, 2016, through December 31, 2018.

8. CDTFA then reduced total alcohol purchases by 2 percent to allow for estimated self-consumption and another 2 percent to allow for estimated pilferage, which resulted in audited costs of alcohol sold of $306,843 for the period 4Q16 through 4Q18.

9. CDTFA compared audited costs of alcohol sold of $135,651 for 2017 and $136,648 for 2018 with appellant's reported total sales for the respective years and computed book markups of 45.78 percent for 2017 and 38.38 percent for 2018.[6] CDTFA found that the computed markups were much lower than expected and concluded that appellant's reported sales were substantially understated.

10. In a prior audit of appellant for the period January 1, 2010, through March 31, 2013, CDTFA compared the gross receipts reported on appellant's FITRs for the years 2010 and 2011 with the costs of goods sold reported on the FITRs for the same years to

[4] CDTFA states that its examination of the detailed information provided by Harbor and Restaurant Depot showed that appellant's purchases of liquor from those vendors were minimal.

[5] Immaterial mathematical discrepancies are due to rounding.

[6] "Markup" is the amount by which the cost of merchandise is increased to set the retail price. For example, if the retailer's cost is $.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .70 =0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

compute a book markup of 463.40 percent for both years combined. In that audit, based on its finding that the book markup of 463.40 percent was reasonable for appellant's business, CDTFA accepted the accuracy of the reported gross receipts and used those amounts to establish audited taxable sales, an approach which was not disputed.[7]

11. To verify that using a markup of 463.40 percent in the audit period at issue would be reasonable, CDTFA researched similar businesses that had been audited previously. CDTFA found audits of two nightclubs located within a 15-mile radius of appellant's business that each had a full bar with minimal sales of food and had entertainment and dancing. In the audit of one of those businesses, CDTFA was provided with sufficient records to compare drink prices with the costs of the beverages sold, which allowed CDTFA to compute an average markup of 444.01 percent. In the audit of the other business, CDTFA relied on records from the business's point-of-sale system to establish audited taxable sales and computed a post-audit markup of 478.63 percent.
12. Because the markup of 463.40 percent from the prior audit of appellant's business was in line with the markups computed in audits of the two aforementioned businesses, CDTFA found that using a markup of 463.40 percent was reasonable for the audit period at issue.
13. CDTFA added the markup of 463.40 percent to audited costs of alcohol sold of $306,843 to establish audited taxable sales of $1,728,756 for the period October 1, 2016, through December 31, 2018.
14. A comparison of audited taxable sales of $1,728,756 for the period October 1, 2016, through December 31, 2018, with appellant's reported taxable sales of $430,087 for the same period showed unreported taxable sales of $1,298,669, which represented a reporting error rate of 301.95 percent. CDTFA applied the reporting error rate to appellant's reported taxable sales for the period January 1, 2019, through September 30, 2019, to compute unreported taxable sales of $555,878 for that period. In total, CDTFA established unreported taxable sales of $1,854,547 ($1,298,669 + $555,878) for the audit period.[8]

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[7] The current audit at issue is appellant's third audit.

[8] Appellant had a limited menu of Mexican-style food, and presumably, it sold food in addition to selling alcoholic beverages. However, CDTFA found that appellant's sales of food likely were immaterial and decided not to establish audited taxable sales of food, which provided at least a minor benefit to appellant.

15. Based on its estimate that appellant withdrew 2 percent of its alcohol from inventory for self-consumption, CDTFA established unreported taxable costs of self-consumed merchandise of $8,528 for the audit period.
16. CDTFA noted that appellant failed to report Orange County district taxes on its return filed for 2Q19. Accordingly, CDTFA established unreported district tax measured by the amount of appellant's reported taxable sales for 2Q19, $62,188.
17. The NOD issued on September 16, 2020, is based on unreported taxable sales of $1,854,547, unreported taxable costs of self-consumed merchandise of $8,528, and unreported district tax measured by $62,188.[9] Additionally, finding that appellant failed to provide complete, reliable records even though it had been audited twice previously, CDTFA added a negligence penalty to the determination.
18. Appellant timely filed a petition for redetermination claiming that it compiled additional records, which would show that the audited understatement was incorrect.
19. In a Decision issued on April 25, 2022, CDTFA noted that appellant failed to provide additional documentation or other evidence supporting a reduction to the determined liability and denied the petition for redetermination.
20. Appellant filed a Request for Reconsideration blaming its tax representative for being neglectful and incompetent and claiming again that it had additional records to provide. However, appellant failed to provide additional records and, in a Supplemental Decision issued on September 6, 2022, CDTFA continued to deny the petition for redetermination.
21. This timely appeal followed.
22. On appeal, appellant provides copies of 23 sales summaries from Restaurant Depot showing items purchased during the period October 28, 2016, through August 11, 2019, including liquor purchases totaling $1,391.33. Appellant also includes a worksheet in which it computed unreported taxable sales of $1,134,407 for the audit period.[10] In its computations, appellant used the markup of 463.40 percent and approximately the same amount for beer purchases as the amount CDTFA used in the audit, but appellant used a

[9] Appellant is not disputing adjustments for unreported self-consumed merchandise or unreported district taxes.

[10] Appellant states that it concedes to unreported taxable sales of $1,134,407. CDTFA asserts that appellant used a markup factor of 463 percent but that it should have used 563 percent (to add back a cost factor of 1, which was done by CDTFA in its calculations), which results in unreported taxable sales of approximately $1.4 million.

lower amount for liquor purchases, $15,687.00, for the period 4Q16 through 4Q18. According to appellant, it used a lower amount for liquor purchases because its sales of liquor represent a much lower percentage of its total sales than its sales of beer.

23. Upon further review of the audit working papers, CDTFA noted some calculation errors. To correct the errors, CDTFA prepared a reaudit and reduced the audited understatement of reported taxable sales by $2,473, from $1,854,547 to $1,852,074, and the unreported taxable costs of self-consumed merchandise by $16, from $8,528 to $8,512.

DISCUSSION

Issue 1: Whether appellant has shown that an additional reduction to the amount 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.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)1).)

If 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.*) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra.*)

Here, the records appellant provided for examination were not sufficient to support the accuracy of appellant's reported taxable sales. Therefore, it was reasonable for CDTFA to use an alternative audit method, the markup method, to establish audited sales. The markup method

is a standard and accepted audit procedure. (See *Appeal of Amaya*, 2021-OTA-328P.) Because the available records only showed purchases of beer, CDTFA estimated costs of liquor sold. Based on photos and videos of appellant's fully stocked bar, CDTFA estimated that appellant's costs of liquor sold were equal to its costs of beer sold. CDTFA asserts that the liquor-to-beer ratio benefits appellant, as liquor purchases are generally higher than beer purchases. CDTFA asserts that one of the similar businesses used for comparison had a liquor-to-beer ratio of 59/41, and generally liquor is 60 to 80 percent of purchases compared to beer. Therefore, based on the liquor-to-beer ratios of similar businesses, it was reasonable for CDTFA to estimate that appellant's costs of liquor sold were roughly equal to its costs of beer sold. Given the absence of detailed purchase records for use in computing appellant's actual markups, OTA also finds that it was reasonable for CDTFA to rely on the book markup computed from appellant's records in a prior audit; in reaching this conclusion, OTA considers that appellant did not contest this markup during the prior audit, and that CDTFA verified that the markup of 463.40 percent was in line with markups confirmed in audits of two similar businesses located near appellant. Therefore, CDTFA's audit methodology was reasonable and rational, and the burden shifts to appellant to establish that an additional reduction to the amount of unreported taxable sales is warranted.

Appellant disputes CDTFA's determination that appellant's purchases of liquor were equal to its purchases of beer. Appellant asserts that it is a "beer bar" and in a smaller part of the neighborhood instead of 15 miles away where the other bars are busier. Appellant asserts that it sells liquor, but that the liquor-to-beer ratio should be 30:70 percent instead of 50:50. Appellant provides sales summaries from Restaurant Depot showing items purchased during the period October 28, 2016, through August 11, 2019. Appellant asserts that the sales summaries indicate less liquor purchases than determined by CDTFA and a liquor-to-beer ratio of approximately 10:90.

Appellant has not provided evidence, such as purchase invoices, to support an adjustment to the determination of its liquor purchases. In a request for additional briefing, OTA stated that the sales summaries showed liquor purchases from Restaurant Depot totaling $1,391.33, but that appellant computed total liquor purchases of $15,687 and asked appellant to provide purchase invoices showing its purchases of liquor adding up to $15,687. In response, appellant did not provide the requested records and stated that it was unable to comply with OTA's request

because its negligent tax preparer held all of its paperwork and receipts from the audit period.[11] Appellant also stated that Restaurant Depot could provide liquor sales, but appellant's other vendor, Southern Wine and Spirit, could not provide purchase invoices for the audit period, so appellant used an estimate. Appellant only provided 23 sales summaries to cover a three-year period. Therefore, appellant acknowledges that it does not have all the necessary documentation to support its alleged liquor-to-beer ratio and that it purchased liquors from vendors from which there is no documentation, as it computed liquor purchases of $15,687 but could only provide sales summaries of liquor purchases totaling $1,391.33.

OTA also notes that appellant previously stated during its briefing and in the computation accompanying the sales summaries that the liquor-to-beer ratio was 90:10, but during the hearing appellant stated that the ratio was 70:30, which also calls into question the reliability of the sales summaries. Furthermore, appellant does not provide complete source documentation to support the sales summaries. In the absence of any additional records or other evidence, appellant has failed to meet its burden and no adjustment is warranted.

Issue 2: Whether the negligence penalty was properly imposed.

R&TC section 6484 provides that, if any part of a 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. Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (*Warner v. Santa Catalina Island Co.* (1955) 44 Cal.2d. 310, 317; see also *People v. Super. Ct.* (2016) 248 Cal. App. 4th 434, 447.) In *Independent Iron Works, Inc. v. State Board of Equalization* (1959) 167 Cal.App.2d 318, 323, the court held that a negligence penalty is justified where errors are continued from one audit to the next.

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to verify the accuracy of any return filed, or, if no return has been filed, to ascertain and determine the amount required to be paid. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include, but are not limited to: (1) the normal

[11] Appellant asserts that its representative stated to him that CDTFA was given records that were never returned. However, the record includes a Form CDTFA-945 Receipt for Books & Records of Account stating that the records provided to CDTFA were returned and appellant's owner acknowledged receipt of those records by signing the form on June 25, 2020.

books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (2) bills, receipts, invoices, cash register tapes, or other documents of original entry; and (3) schedules of working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and provide complete and accurate records will be considered evidence of negligence or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

CDTFA imposed the negligence penalty based on its finding that appellant was aware of its recordkeeping responsibilities following two prior audits but still provided inadequate records for the audit period at issue here such that CDTFA was required to use an indirect audit approach to establish audited taxable sales. Further, CDTFA found that the magnitude of the understatement was evidence of negligence. Appellant asserts that the lack of records provided for audit was due to neglect, disregard, and incompetency by its tax preparer. Appellant asserts that it was unable to comply with OTA's request for complete purchase invoices because its negligent tax preparer held all of its paperwork and receipts from the audit period.

OTA notes that appellant failed to correct its reporting errors even after understatements were disclosed in its two prior audits. In addition, appellant concedes that it underreported taxable sales by $1,134,407. A comparison of reported taxable sales of $614,180 for the audit period at issue here with audited taxable sales of $2,466,254[12] shows that appellant reported only one-fourth of its taxable sales ($614,180 ÷ $2,466,254). OTA finds that appellant's reporting errors are significant and constitute evidence of negligence.

In addition, appellant failed to provide complete sets of purchase invoices, credit card merchant statements, and cash register Z-tapes. The general ledger appellant provided was unreliable, given that CDTFA found that appellant recorded purchases from only one of its vendors. Appellant's failure to provide complete and reliable records following the experience gained from two prior audits is evidence of negligence. (See *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, 167 Cal.App.2d at p. 323.)

To the extent that appellant was uninformed and relied upon its bookkeeper to report sales accurately and to represent appellant during the audit, OTA finds that appellant remains responsible for the negligence of its agent. Given the inadequacy of the records provided for

[12] Adding unreported taxable sales of $1,852,074 to appellant's reported taxable sales of $614,180 results in audited taxable sales of $2,466,254.

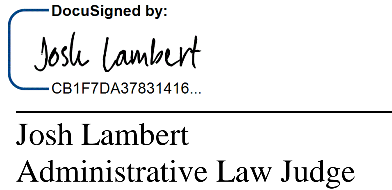
audit and the magnitude of the reporting errors, OTA concludes that the negligence penalty was properly imposed.

HOLDINGS

1. Appellant has not shown that an additional reduction to the amount of unreported taxable sales is warranted.
2. The negligence penalty was properly imposed.

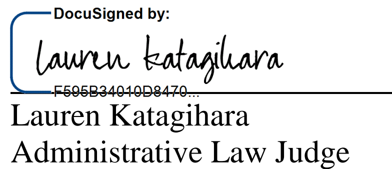
DISPOSITION

Sustain CDTFA's actions in reducing the determined tax from $145,081 to $144,884, and the negligence penalty from $14,508.08 to $14,488.43, and otherwise denying the petition.

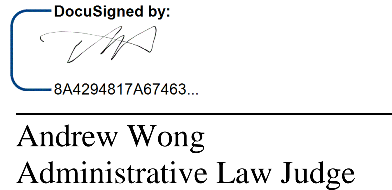


Josh Lambert
Administrative Law Judge

We concur:



Lauren Katagihara
Administrative Law Judge



Andrew Wong
Administrative Law Judge

Date Issued: 5/10/2024