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2024-OTA-442
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 230212625
THELN VENTURES LLC,	)	CDTFA Case ID: 193-054
dba Wingstop 0263, 0352, 0490	)	

OPINION

Representing the Parties:

For Appellant: Thunyga Lu

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, TheLN Ventures LLC (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 January 18, 2018.[2] The NOD is for tax of $696,121.89, plus applicable interest, and a penalty of $69,612.25 for the period April 1, 2014, through March 31, 2017 (liability period).[3]

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

ISSUES

[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 timely issued because on September 18, 2017, appellant signed a waiver of the otherwise applicable three-year statute of limitations for the period April 1, 2014, through September 30, 2014, which allowed CDTFA until April 30, 2018, to issue an NOD. (R&TC, §§ 6487(a), 6488.)

[3] The NOD reflects a payment of $190 made on September 25, 2017.

1. Whether any adjustments to the amount of unreported taxable sales are warranted.
2. Whether the negligence penalty was properly imposed.

FACTUAL FINDINGS

1. Appellant, a limited liability company, operated three Wingstop franchises: two in Hayward, California, and one in Alameda, California. Appellant's seller's permit was opened with an effective start date of December 10, 2013. Appellant had not been previously audited.
2. CDTFA prepared an audit and a revised audit. The following is an explanation of the computation of audited taxable sales in the revised audit dated September 19, 2017, which is the basis for the NOD.
3. For the liability period, appellant reported on its sales and use tax returns total sales of $1,089,460 and claimed deductions of $13,322 for nontaxable sales of food products and $13,723 for bad debts, resulting in reported taxable sales of $1,062,415. Upon audit, CDTFA requested appellant's books and records, but appellant did not provide the requested documents;[4] as a result, CDTFA was unable to verify appellant's reporting method. Thus, CDTFA decided to verify reported taxable sales using an indirect audit method, the credit-card-sales-ratio method.
4. Based on a site visit, CDTFA concluded that appellant's food sales met the 80/80 rule; thus, all sales of food would be subject to sales tax unless appellant kept a separate accounting of its cold food sales to-go.[5]
5. CDTFA obtained appellant's Form 1099-K[6] data from the IRS. Using that information, CDTFA compiled credit card sales of $3,377,678 for April 1, 2014, through December 31, 2015.

[4] CDTFA's entries in the audit workpapers' Assignment Activity History reflect that during the period from December 2016 to September 2017, CDTFA made multiple requests to appellant to allow CDTFA to review appellant's books and records, but appellant did not provide any documents.

[5] The general rule is that a sale of cold food to-go is exempt from tax. (Cal. Code Regs., tit. 18, § 1603(c)(1)(B).) However, there is a special "80/80" rule under which a sale of cold food to-go in a form suitable for consumption on the retailer's premises (e.g., a cold sandwich) is subject to tax. This rule applies when more than 80 percent of a retailer's gross receipts are from sales of food products, and over 80 percent of the retailer's sales of food are otherwise subject to tax. (R&TC, § 6359(d)(6); Cal. Code Regs., tit. 18, § 1603(c)(1)(A), (c)(3).)

[6] Form 1099-K is an IRS form titled, "Payment Card and Third Party Network Transactions," which shows the monthly and annual amounts paid to a merchant by a bank, credit card company, or third party network during a

6. Because appellant did not provide the requested sales records, CDTFA estimated a credit card sales ratio of 65 percent based on its site review and experience in audits of similar businesses in appellant's area.
7. CDTFA divided credit card sales by the estimated credit card sales ratio of 65 percent to compute total sales of $5,196,428 for April 1, 2014, through December 31, 2015. CDTFA compared that amount to reported total sales of $678,861 for April 1, 2014, through December 31, 2015, resulting in a difference of $4,517,567. CDTFA computed an error ratio[7] for each quarter of that period, which resulted in an average error ratio of 665.46 percent for that period.
8. CDTFA multiplied reported total sales for each quarter by the respective error ratio, and for the period January 1, 2016, through March 31, 2017, by the 665.46 percent error ratio and computed unreported taxable sales (including sales tax reimbursement) of $7,935,343 for the liability period. CDTFA multiplied unreported taxable sales (including sales tax reimbursement) by two thirds (66.67 percent) to allocate unreported taxable sales (including sales tax reimbursement) to the Hayward locations and one third (33.33 percent) to allocate unreported taxable sales (including sales tax reimbursement) to the Alameda location. For each quarterly period, CDTFA divided unreported taxable sales (including sales tax reimbursement) for Hayward and Alameda locations by 1 plus the applicable sales tax rate to compute unreported taxable sales (excluding sales tax reimbursement) of $7,239,523 ($4,820,084 Hayward locations + $2,419,439 Alameda location) for the liability period.
9. Based on the revised audit, CDTFA issued the NOD to appellant on January 18, 2018, for tax of $696,121.89, plus applicable interest, and a negligence penalty of $69,612.25.
10. Appellant filed a timely petition for redetermination dated January 29, 2018, protesting the NOD in its entirety.
11. CDTFA held an appeals conference with appellant on September 28, 2022, and issued a Decision on January 18, 2023, denying appellant's petition.
12. Appellant timely appealed to OTA on February 14, 2023.

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given time period. Form 1099-K includes payments made by any electronic means, including, but not limited to, credit cards, debit cards, and PayPal.

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

13. On appeal to OTA, CDTFA provided updated audit work papers that it prepared based on additional information that it received after issuance of the NOD, consisting of appellant's Form 1099-K data for 2016 and 2017, and appellant's franchisor sales information for 2016, 2017, and 2018. Using that additional data, CDTFA calculated that appellant's unreported taxable sales for the liability period were higher than the amounts determined in the revised audit, and would increase appellant's tax liability by $1,285,232 for the liability period. In briefing to OTA, CDTFA states that due to the statute of limitations, it is not asserting any increase.

DISCUSSION

Issue 1: Whether any adjustments to the amount of unreported taxable sales are 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.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) To satisfy its burden of proof, a taxpayer must prove both: 1) that the tax assessment is incorrect, and 2) the proper amount of the tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

Here, appellant failed to provide its books and records for audit; thus, CDTFA was unable to verify sales reported on appellant's sales and use tax returns for the liability period

using a direct audit method (that is, compiling audited sales directly from appellant's records). 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 sales and use tax returns. (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).) Given appellant's lack of records, OTA finds that it was reasonable for CDTFA to question reported sales and use an indirect audit method to compute appellant's sales. CDTFA's use of the credit-card-sales-ratio method as the basis for its determination is a recognized and accepted accounting procedure. (*Appeal of Amaya*, 2021-OTA-329P.) OTA also finds that Form 1099-K data is evidence from third parties of appellant's sales paid by credit card and is a reliable source of data from which to establish audited sales. Therefore, OTA concludes that CDTFA has established that its determination is reasonable and rational, and accordingly, the burden shifts to appellant to show errors in the audit.

Appellant contends that its financial books and records were recorded by a point-of-sale (POS) system which accurately tracked daily sales. Appellant argues that "the tax liability in this case should be calculated based [on] actual sales recorded in the franchisor's POS system and the bank deposits rather than based on an indirect method like extrapolation which is highly susceptible to statistical and extrapolation errors." Appellant has not provided any supporting documentation or evidence to support its contentions in its appeal with OTA.

There is no requirement that CDTFA must use one audit method over another. Furthermore, even if appellant had provided books and records that were comprehensive and internally consistent, CDTFA would not be required to accept those as conclusive if CDTFA, using recognized and standard accounting procedures, established in an audit that the books and records did not disclose the correct amount of tax liability. (*Appeal of Amaya*, *supra* (citing R&TC, § 6481 and *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 614-615).) As discussed above, OTA concludes that CDTFA's determination was reasonable and rational, and accordingly, the burden shifted to appellant to show errors in the audit. Therefore,

appellant must provide evidence sufficient to establish that a result differing from CDTFA's determination is warranted. (*Appeal of Talavera*, *supra*.)

Appellant has not provided any documentation or other evidence to support that adjustments to CDTFA's calculation of audited taxable sales using the credit-card-sales-ratio method are warranted. Accordingly, OTA finds no basis to recommend adjustments for appellant's position.

Moreover, following issuance of the NOD, CDTFA obtained Form 1099-K data for 2016 and 2017; and appellant's franchisor sales information for 2016, 2017, and 2018. CDTFA's updated audit workpapers reflect that reliance on the updated information results in higher amounts of unreported taxable sales for the liability period; therefore, CDTFA states that reductions to the audited measure are not warranted. OTA finds that these results provide further support for the conclusion that no adjustments are warranted.

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 documentation or other evidence in support of its contentions from which a more accurate determination could be made. The taxpayer cannot carry its burden of proof simply by asking OTA to find unidentified errors in CDTFA's determination. (*Appeal of Amaya*, *supra*.) As appellant bears the burden of proof in this case, OTA must conclude that no adjustments are warranted.

Issue 2: Whether the negligence penalty was properly imposed.

Appellant has not explicitly disputed the negligence penalty in its appeal here. However, out of an abundance of caution, OTA will address the negligence penalty.

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. Superior Court* (*Sokolich*) (2016) 248 Cal. App. 4th 434, 447.) Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that any bookkeeping and reporting errors cannot be attributed to the

taxpayer's good faith and reasonable belief that its bookkeeping and reporting practice were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A); see also *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

A taxpayer shall maintain and make available for examination on request by CDTFA, 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 sales and use tax return. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b).) All records required to be retained under this regulation must be preserved for a period of not less than four years. (Cal. Code Regs., tit. 18, § 1698(i).) Failure to maintain and keep complete and accurate records will be considered evidence of negligence or intent to evade the tax and may result in penalties or other appropriate administrative action. (Cal. Code Regs., tit. 18, § 1698(k).)

CDTFA imposed the negligence penalty because appellant failed to maintain and provide its books and records for audit, and the audit disclosed a substantial understatement of taxable sales. CDTFA noted that it made multiple attempts to obtain books and records from appellant.

OTA finds that appellant's failure to provide books and records supporting sales for audit is evidence of negligence. Moreover, a comparison of unreported taxable sales of $7,239,523 computed in the revised audit to reported taxable sales of $1,062,415 results in an error rate of 681 percent ($7,239,523 ÷ $1,062,415). This large understatement and large error ratio are further evidence of negligence.

In light of the above, OTA finds that appellant did not have a good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law. OTA also finds that appellant did not exercise the care that a reasonable and prudent person would exercise under similar circumstances. Although this is appellant's first audit, OTA finds that the negligence penalty was properly imposed.

HOLDINGS

1. Appellant has not shown that adjustments to unreported taxable sales are warranted.
2. The negligence penalty was properly imposed.

DISPOSITION

OTA sustains CDTFA's action in denying appellant's petition.

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Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

We concur:

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Natasha Ralston
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Natasha Ralston
Administrative Law Judge

DocuSigned by:
Kim Wilson
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Kim Wilson
Hearing Officer

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