OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 21017124
	CDTFA Case ID: 240-020
INTERNATIONAL GREEN AUTO, dba Mr. Kebab & Falafel[1]	

OPINION

Representing the Parties:

For Appellant: Amjad Alasad, Partner

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Lisa Burke, Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, International Green Auto (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[2] denying appellant's administrative protest of a Notice of Determination (NOD) issued on May 19, 2014. The NOD is for tax of $14,592.89, plus applicable interest, for the period October 1, 2010, through December 31, 2012 (liability period). Pursuant to R&TC section 6565, an additional 10 percent penalty of $1,459.29 was added to the NOD for appellant's failure to timely pay the NOD before it became final (finality penalty).[3]

After issuing the NOD, CDTFA completed a reaudit, which reduced the tax by $571.89, from $14,592.89 to $14,021. CDTFA also reduced the finality penalty to $1,402.10.

[1] During the liability period, International Green Auto (appellant) operated a restaurant serving Mediterranean-style food. Appellant also operated an auto dealership, which was inactive during the liability period at issue (October 1, 2010, through December 31, 2012) and was not included in the audit of appellant's business.

[2] 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.

[3] The NOD was issued timely because appellant signed a waiver of the otherwise applicable three-year statute of limitations on March 25, 2014, which extended until July 31, 2014, the time within which CDTFA could issue an NOD for the period October 1, 2010, through March 31, 2011. (See R&TC, §§ 6487(b), 6488.)

Additionally, CDTFA agreed to relieve the finality penalty if appellant pays the tax in full within 30 days after the mailing of the notice of final decision in this appeal.

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

ISSUE

Whether an additional reduction to the measure of unreported taxable sales is warranted.

FACTUAL FINDINGS

1. Appellant, a partnership, operated a restaurant selling Mediterranean-style food and alcoholic beverages in Capitola, California, from October 1, 2010, through June 30, 2017.
2. During the liability period, appellant closed its business for six weeks beginning in March 2011, due to flooding, and during the period beginning some time in November 2011 through a portion of May 2012 due to vandalism. Appellant reported total sales of $298,505 and claimed deductions of $75,401, resulting in taxable sales of $223,104. Appellant's claimed deductions included claimed exempt food sales of $56,297 and sale tax reimbursement included in reported total sales of $19,104.
3. For the audit, appellant did not provide a complete set of books and records. Instead, appellant provided the following: federal income tax returns for 2010 and 2011; a point of sales (POS) report for the second quarter of 2012 (2Q12) through 4Q12; bank statements for the period January 2011 through December 2012; daily POS reports for the period April 22, 2013, through May 5, 2013; and guest checks and sales summary reports for February 13, 2013, March 23, 2013, and August 20, 2013.
4. The gross receipts reported on appellant's 2011 federal income tax return exceeded the total sales reported on appellant's sales and use tax return for the same period by $217,768.[4] The bank deposits recorded on appellant's bank statements during the period January 2011 through September 2012 exceeded reported total sales during that period by $416,488. The total sales recorded on appellant's POS reports for the period 2Q12

[4] Appellant's 2010 federal income tax return was a partial year return including gross receipts from the business's start date in October 2010. The gross receipts reported on appellant's 2010 federal income tax return reconciled with the total sales reported on appellant's sales and use tax returns for 4Q10.

through 4Q12 exceeded reported total sales during that period by $33,146. Based on this information, CDTFA concluded that further audit work was warranted.

5. CDTFA conducted full-day sales observations of appellant's restaurants on the following three days: Wednesday, February 13, 2013; Saturday, March 23, 2013; and Tuesday, August 20, 2013. In total, CDTFA observed total sales of $2,345, including credit card sales of $1,430.12, and cash sales of $684.70. CDTFA also observed that 1.73 percent of appellant's sales were sales of cold food to go.

6. CDTFA also compiled the total sales recorded in appellant's daily POS reports for the period April 22, 2013, through May 5, 2013. Appellant recorded total sales of $9,768.19, including credit card sales of $6,453.27 and cash sales of $2,425.55. CDTFA combined this information with the results of the site observations to calculate a credit card sales rate of 71.18 percent, a credit card tips rate of 12.44 percent and a total (credit card plus cash) optional tips rate of 8.57 percent.

7. CDTFA compiled the credit card sales deposited in appellant's bank statements of $294,058 for the period January 1, 2011, through December 31, 2012. CDTFA reduced appellant's credit card deposits by the credit card tip ratio of 12.44 percent to compute credit card sale excluding tips. CDTFA then applied the 71.18 percent credit card sales ratio to find audited total sales of $361,750. CDTFA reduced the audited total sales by the sales tax reimbursement recorded on appellant's sales and use tax returns to find audited taxable sales of $344,506.

8. The audit workpapers state that 80 percent of appellant's gross receipts come from the sale of food products and more than 80 percent of appellant's sales of food are subject to tax, and that appellant is subject to the 80/80 rule.[5] Based on this, CDTFA concluded that all of appellant's sales are subject to tax. Despite this finding, CDTFA reduced audited taxable sales by 1.73 percent for sales of cold food to go to compute adjusted taxable sales of $338,539.[6] CDTFA subtracted appellant's reported taxable sales of

[5] The 80/80 rule is discussed in greater detail below.

[6] According to the audit workpapers, appellant explained without documentation that a menu change increased the number of taxable sales. Appellant asserted that there were more nontaxable sales under the old menu. The audit workpapers state that "taxpayer has no prior audit and for reasonable purposes auditor allowed" the adjustment for sales of cold food to go.

$203,010 from the adjusted taxable sales to calculate unreported taxable sales of $135,529 for the period 1Q11 through 4Q12.

9. When compared to reported taxable sales of $203,010 for 1Q11 through 4Q12, appellant's unreported taxable sales of $135,529 represents an error rate of 66.76 percent. CDTFA applied the 66.76 percent error rate to appellant's reported taxable sales of $20,094 to find unreported taxable sales of $13,415 for 4Q10. In total, CDTFA computed unreported taxable sales of $148,944 ($135,529 + 13,415).

10. Although the sales tax rate in Capitola decreased from 9.25 percent to 8.25 percent effective July 1, 2011, appellant continued to collect sales tax reimbursement at the rate of 9.25 percent throughout the liability period. A comparison of recorded sales tax reimbursement collected for the period 2Q12 through 4Q12 with appellant's reported tax for the same quarters showed that appellant collected excess sales tax reimbursement of $1,300, which represented an error rate of 14.29 percent. CDTFA applied the error rate to appellant's reported tax for 3Q11 and 4Q11 to compute additional excess sales tax reimbursement of $507. In total, appellant collected excess sales tax reimbursement of $1,807, represented by a taxable measure of $38,044.[7]

11. CDTFA issued the NOD on May 19, 2014. Appellant did not timely pay or protest the NOD and it became final on June 19, 2014. CDTFA added a finality penalty pursuant to R&TC section 6565. On September 10, 2014, appellant filed an untimely protest of the NOD, which CDTFA accepted as an administrative protest.

12. CDTFA issued a Decision and a Revised Decision.[8] In the Revised Decision, CDTFA ordered a reaudit to reduce the error rate applied to appellant's reported taxable sales for 4Q10 from 66.76 percent to 36 percent. CDTFA's reaudit was based on the submission of additional documents provided by appellant, which resulted in a reduction of $6,181[9] to the audited amount of unreported taxable sales from $148,944 to $142,762.

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[7] On appeal, appellant does not present any argument or evidence with respect to the measure of excess sales tax reimbursement collected. Therefore, OTA does not consider it in dispute and will not discuss it further.

[8] CDTFA issued the Revised Decision to correct its presentation of an incorrect measure of tax, which resulted from a calculation error. CDTFA also corrected the Decision's omission of a conditional requirement concerning the finality penalty.

[9] CDTFA's Decision lists this reduction as $6,182. This difference appears to be the result of rounding.

13. CDTFA's Revised Decision also notes several computational errors in the audit including: the calculation of the credit card ratio; the calculation of the credit card tip ratio; the method used to reduce audited taxable sales by the sales tax reimbursement collected. CDTFA found that correcting these errors would increase the taxable measure, which was barred by statute. As a result, CDTFA ordered that no change be made to correct these errors.

14. This timely appeal followed.

DISCUSSION

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.*)

In general, sales of food are exempt from tax. (R&TC, § 6359.) However, certain sales of food are excluded from the exemption (and are thus subject to tax). As relevant here, sales of food are subject to tax if the food is sold for consumption at facilities provided by the retailer (R&TC, § 6359(d)(2)) or if the food is sold as hot prepared food products (R&TC, § 6359(d)(7)).

When more than 80 percent of a retailer's gross receipts are from sales of food products, and over 80 percent of its retail sales of food are subject to tax, then cold food sold in a form suitable for consumption on the retailer's premises is subject to tax even if it is purchased "to

go." (R&TC, § 6359(d)(6).) When a retailer's sales fit within this provision, often referred to as the "80/80 rule," the retailer may avoid its application by keeping a separate accounting of its sales of cold food to go in a form suitable for consumption on the retailer's premises. (R&TC, § 6359(f); Cal. Code Regs., tit. 18, § 1603(c)(1)(A).)

When a right to an exemption from tax is involved, the taxpayer has the burden of proving its right to the exemption. (*H. J. Heinz Co. v. State Bd. of Equalization* (1962) 209 Cal.App.2d 1, 4.) Any taxpayer seeking exemption from the tax must establish that right by the evidence specified by the relevant regulation. A mere allegation that sales are exempt is insufficient. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442.)

Here, appellant did not provide a complete set of books and records for the audit. CDTFA reviewed the available books and records and found discrepancies that could not be explained. For example, the gross receipts reported on appellant's federal income tax return for 2011 exceeded the total sales that appellant reported on its sales and use tax returns by $217,768. Similarly, amounts recorded on appellant's bank statements and in appellant's POS reports exceeded the amounts reported on appellant's sales and use tax returns. When CDTFA cannot compute taxable sales from appellant's records, it is appropriate to use an indirect approach to calculate the taxable measure. (See *Appeal of Amaya*, 2021-OTA-328P.)

To calculate appellant's taxable sales, CDTFA used information obtained through three full day observations and appellant's daily POS records to calculate a credit card ratio, as well as an average percentage of tips included in credit card receipts. CDTFA then established audited taxable sales by applying the credit card ratio and credit card tips ratio to appellant's credit card bank deposits for the period 1Q11 through 4Q12.[10] OTA has previously found that the credit card sales ratio method is a recognized and accepted audit method. (*Appeal of Amaya, supra.*) CDTFA also calculated an error rate based on the results of the credit card projection, which was used to compute unreported taxable sales for 4Q10. Upon reaudit, CDTFA corrected its calculation of the error rate, which reduced the taxable measure.

Next, CDTFA observed that only 1.73 percent of sales were sales of cold food to go. Because more than 80 percent of appellant's gross receipts were from sales of food products, and over 80 percent of its retail sales of food were subject to tax, then appellant's sales of cold food

[10] As discussed above, CDTFA found several computational errors with the credit card ratio and credit card tips ratio. However, CDTFA determined that it was barred by statute from fixing the errors, which would increase the liability. As this is to appellant's benefit, OTA will not discuss it further.

to go were also subject to tax. (R&TC, § 6359(d)(6).) Nevertheless, CDTFA reduced appellant's audited total sales by the exempt food sales ratio of 1.73 percent. Thus, in light of the foregoing, it was reasonable and rational for CDTFA to use the combined observations and appellant's own POS reports to calculate the audited taxable sales. Accordingly, the burden shifts to appellant to show whether a reduction is warranted. (*Appeal of Talavera, supra.*)

On appeal, appellant contends that the audit liability is overstated. First, appellant argues that CDTFA's calculation is based on an observation of sales that occurred after the liability period. Appellant contends that its sales increased over time. For example, appellant asserts that sales increased after the addition of a takeout window during the liability period. Appellant also asserts that, during the liability period, it only operated for nine months. As an explanation, appellant asserts that it was closed for several months due to vandalism and that the business is seasonal. In addition, the audit workpapers indicate that appellant was closed for six weeks beginning in March 2011, due to flooding. Finally, appellant asserts that most of its sales were nontaxable sales of cold food to go.

Here, there is no dispute that CDTFA's observation test occurred after the liability period. However, the observation test was not solely determinative of the taxable measure. Instead, the observed sales and appellant's own records were used to determine appellant's credit card sales ratio, which CDTFA used to project appellant's sales during the liability period. As discussed above, CDTFA's audit method is reasonable and rational.

OTA notes that the credit card ratio accounts for business fluctuations and closures. For example, appellant's business closed for several months after an instance of vandalism. A review of the audit workpapers reveals that appellant made zero credit card sales during the period December 2011, through April 2012.[11] Thus, any application of the credit card ratio would result in zero additional sales. Indeed, the taxable measure includes zero unreported taxable sales for the months of December 2011 through December 2012. On the other hand, in months where appellant's credit card deposits increased, so did the taxable measure. For example, in July 2012, appellant had credit card deposits of $25,588 and the audited taxable sales were $31,478. Appellant has not provided any documentation to show that the credit-card ratio

[11] The available evidence shows that the vandalism occurred in November 2011. Appellant's credit card sales for that month were only $4,741 and the audited measure of total sales (including tax) were $5,832.

should be reduced for any part of the liability period. As such, OTA finds that no reduction is warranted based on fluctuations in appellant's business.

Regarding appellant's argument that most of its sales were exempt sales of cold food to go, OTA notes that CDTFA observed a cold food to go sales rate of 1.73 percent. Therefore, under the 80/80 rule provided by R&TC section 6359(d)(6), tax applied to all of appellant's sales, including its sales of cold food to go. Nevertheless, CDTFA reduced audited total sales by the exempt food sales ratio of 1.73 percent to establish audited taxable sales. Appellant has not provided any evidence that the exempt food sales ratio is greater than 1.73 percent or that the 80/80 rule is inapplicable. Therefore, no further reductions to the taxable measure are warranted. Appellant has not met its burden of proof. (*Appeal of Talavera, supra.*)

HOLDING

No additional reduction to the measure of unreported taxable sales is warranted.

DISPOSITION

Sustain CDTFA's actions in reducing the amount of unreported taxable sales by $6,181, from $148,944 to $142,763, and otherwise denying the administrative protest.

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Keith T. Long
Administrative Law Judge

We concur:

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Huy "Mike" Le
Administrative Law Judge

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