OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **BEE MANAGEMENT, INC.,** **dba Tee Up Restaurant & Bar**	OTA Case No. 231014492 CDTFA Case ID: 02-923-080

OPINION

Representing the Parties:

For Appellant: Manuel A. Almeida, Representative

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Corin Saxton, Attorney

K. WILSON, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Bee Management, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on June 11, 2021. The NOD is for tax of $122,905, plus applicable interest, for the period January 1, 2016, through December 31, 2018 (liability period).

Office of Tax Appeals (OTA) Hearing Officer Kim Wilson and Administrative Law Judges Natasha Ralston and Michael F. Geary held an oral hearing for this matter in Cerritos, California, on September 10, 2024. At the conclusion of the oral hearing, the record was closed, and this matter was submitted on the oral hearing record pursuant to California Code of Regulations, title 18, (Regulation) section 30209(b).

[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.

ISSUE

Whether adjustments are warranted to the deficiency measure for unreported admission fees.

FACTUAL FINDINGS

1. Appellant, a California corporation, has operated a private club and cocktail lounge located on the street level of the Westin Bonaventure hotel in downtown Los Angeles, California, since September 2, 2004. Appellant's club is an exclusive bar that caters to wealthy Japanese businessmen and where only members and their guests are served. Appellant also owns a related non-exclusive cocktail lounge in Torrance, California.
2. Appellant offers various levels of membership, which provide access to the lounge and bar for an additional cost, as well as other services, such as exclusive reservation and concierge services.[2] Appellant primarily sells alcoholic beverages but also offers a limited food menu.
3. Members and guests pay an admission fee of $120 to access the establishment for two hours (with an additional fee of $10 for each hour thereafter). An additional fee of $30 applies for seating at the bar, and a fee of $10 applies for use of the karaoke facilities.
4. Upon audit, appellant provided federal income tax returns (FITRs) for 2016 and 2017, sales worksheets for the liability period, purchase invoices for December 2018, and the general ledger for 2018.
5. During the liability period, appellant collected membership fees totaling $253,800, which appellant did not include in its reported total sales. Although CDTFA determined that

[2] There are three membership levels: silver; gold, and platinum. The silver membership level costs $250 and includes concierge service in Japan and discounts for the Westin Bonaventure hotel in Los Angeles. The gold membership level costs $500 and includes the silver membership level benefits as well as the rights to reserve a VIP room or table and to purchase an exclusive bottle of wine/sake/champagne twice a year at cost. The platinum membership level costs $1,000 and includes the gold membership level benefits as well as a pickup and drop off service and the right to buy two bottles and receive a third bottle for free, excluding Japanese whisky, vintage wine, champagne and sake.

some portions of the membership fees were subject to tax, CDTFA did not create a deficiency measure for unreported taxable membership fees.[3]

6. CDTFA observed that, based on the FITRs, combined operating costs consisting of cost of goods sold and administrative expenses were $2,475,850 for 2016 and 2017, yet reported taxable sales were only $1,268,407 for these years.[4]

7. CDTFA performed a book markup analysis using reported taxable sales and the cost of goods sold per the FITRs.[5] CDTFA's analysis disclosed an average markup of 225.24 percent for 2016 and 2017 for the alcoholic drinks.[6] Based on the location and clientele, CDTFA found that this markup was lower than the expected markup of 400 to 500 percent. CDTFA also found that the admission fees compensated for the low markup on drinks, which CDTFA expected to be at least 300 percent. Therefore, CDTFA established a deficiency measure of $1,341,325 for unreported taxable admission fees.[7] CDTFA also calculated a book markup of 297 percent for alcoholic drinks sold in appellant's related non-exclusive cocktail lounge in Torrance.

8. CDTFA issued the NOD to appellant on June 11, 2021, for tax of $122,905, plus applicable interest.

9. Appellant filed a timely petition for redetermination on July 7, 2021.

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[3] Membership fees related to the anticipated retail sale of tangible personal property are includible in the taxable gross receipts when the retailer sells its product for a lower price to a person who had paid the membership fee than to a person who has not paid the fee. (Cal. Code Regs., tit. 18, § 1584.) CDTFA did not prorate the membership fees between taxable and nontaxable portions as it was unclear to CDTFA whether appellant had the records required for such a computation. CDTFA advised appellant to maintain documentation to support nontaxable membership fees in the future.

[4] Appellant reported taxable sales of $1,268,407, which is calculated by starting with total sales of $1,383,126 less claimed sales tax included of $114,445 and other deductions of $274 for 2016 and 2017.

[5] "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.

[6] The calculated markup for 2016 was 243.20 percent. CDTFA initially calculated the markup for 2017 as 186.97 percent with a combined markup of 218.06 percent for both years. However, CDTFA found that taxable sales reported in the first quarter of 2018 (1Q18) belonged in 2017 and when the markup was recalculated it was 203.03 percent. However, there are calculation errors in the markup totals column which when calculated correctly equals 225.24 percent.

[7] CDTFA also identified a deficiency measure of $3,000 for purchases subject to use tax. This audit item is not in dispute.

10. CDTFA held an appeals conference with appellant on February 22, 2023, and issued a decision on April 26, 2023, denying appellant's petition.
11. Appellant timely requested reconsideration of the decision with CDTFA on May 25, 2023.
12. CDTFA issued a supplemental decision on September 7, 2023, again denying appellant's petition.
13. Appellant timely appealed to OTA on October 3, 2023.

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.)

A sale includes the furnishing, preparing, or serving for a consideration of food, meals, or drinks. (R&TC, § 6006(d).) The gross receipts from a sale also include any services that are a part of the sale, and any amount for which credit is allowed by the seller to the purchaser. (R&TC, § 6012(b)(1), (3).) Thus, an admission charge solely to attend entertainment such as a concert or theater is nontaxable because there is no "sale" within the meaning of the R&TC. On the other hand, an admittance charge that is in the nature of a minimum charge for the sale of tangible personal property, such as food or drink, is taxable as a part of the sale of the tangible personal property.

Similar to Regulation section 1603(i)(4), which pertains to premises provided by caterers, separately stated charges for the lease of premises on which meals, food, or drinks are served, are nontaxable leases of real property. Where a charge for leased premises is a guarantee against a minimum purchase of meals, food or drinks, the charge for the guarantee is gross receipts subject to tax. (*Ibid.*) Where a person contracts to provide both premises and meals, food or drinks, the charge for the meals, food or drinks must be reasonable in order for the charge for the premises to be nontaxable. (*Ibid.*) In summary, in order to determine the taxability of an admission charge it is necessary to determine the nature of the charge; that is, is the charge in the nature of

a taxable charge for tangible personal property or a nontaxable charge for a service or entertainment.

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; Regs. § 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*.)

Here, appellant's reported taxable sales for 2016 and 2017 were significantly lower than appellant's operating costs for these years ($1,207,443 lower without considering the membership fees of $253,800 and $953,643 lower if those fees are considered). Appellant has been in business since September 2004 yet has not shown adequate sales to cover its costs during the liability period. This is persuasive evidence that appellant was attempting to shift revenue from a taxable category (food and alcohol sales) to a potentially nontaxable category (admission fees or services unrelated to taxable sales).

Further, appellant's average book markup of 225 percent is lower than expected for a bar and lounge, let alone for a members-only bar and lounge. In addition, appellant's 225 percent book markup is lower than the book markup of 297 percent for its related non-exclusive cocktail lounge in Torrance. CDTFA determined that the markup was insufficient based on the available books and records and used an alternative auditing method to determine taxable sales that included taxable admission fees. CDTFA reasoned that the admission fees were taxable because they subsidized an unreasonably low markup on alcohol sales. OTA calculated audited markups

of 477 percent and 447 percent for 2016 and 2017, respectively.[8] Therefore, OTA finds that it was reasonable for CDTFA to determine that appellant's admission fees were a part of the cost of appellant's sales of food and drink. In other words, the admissions charges are in the nature of a minimum charge for taxable sales of food and drink and are thus taxable as part of the sale of the tangible personal property. (See R&TC, §§ 6006(d), 6012(b)(1).)

On appeal, appellant argues that its admission fees are not related to appellant's sale of tangible personal property because appellant separately stated the admission fees. In support of its argument, appellant cites to Sales and Use Tax Annotation (Annotation) 550.0680, which, according to appellant, provides that charges for admission to a place furnishing entertainment which are billed separately from minimum charges for meals or drinks are not subject to tax.[9] Appellant also argues that a book markup of 200 to 300 percent should be considered reasonable.[10]

Appellant's reliance on Annotation 550.0680 is misplaced. Annotation 550.0680 pertains to admission charges for theatre restaurants and states, "Charges for admission to a place furnishing entertainment which are billed separately from minimum charges for meals or drinks are not subject to tax." Based on the record, appellant provided minimal entertainment (i.e., karaoke),[11] and its main revenue was from alcohol sales. Appellant also argues that a book markup of 200 to 300 percent should be considered reasonable. However, as discussed earlier, appellant's reported taxable sales for 2016 and 2017 were significantly lower than appellant's

[8] OTA calculated the audited markup from information in the audit working papers using the following formula: audited sales less cost of goods sold (COGS) = gross profit; gross profit divided by COGS = audited markup. For 2016: audited taxable sales of $1,271,973 – COGS of $220,510 = gross profit of $1,051,463; gross profit of $1,051,463 ÷ COGS of $220,510 = audited markup of 476.83 percent. For 2017: audited taxable sales of $975,724 – COGS of $178,279 = gross profit of $797,445; gross profit of $797,445 ÷ COGS of $178,279 = audited markup of 447.30 percent.

[9] CDTFA's annotations do not have the force or effect of law but may be entitled to some consideration by OTA. (*Appeal of Praxair, Inc*., 2019-OTA-301P, citing *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 15.)

[10] Appellant also expresses concern that CDTFA has not provided guidance as to how high the markup would need to be for the admission fees to be nontaxable. OTA does not issue advisory opinions. (Cal. Code Regs., tit. 18, § 30103(b).)

[11] Appellant contends that the main purpose of the members is to socialize in a friendly and safe environment. However, appellant asserts that it is impossible to put an entertainment value on this business. Appellant also provides hostesses for its members but does not state whether this is part of the entertainment it provided. Karaoke, which requires an additional $10 charge to participate in, is the only entertainment that is quantified in the sales reports.

operating costs for these years ($1,207,443 lower without considering the membership fees of $253,800 and $953,643 lower if those fees are considered). Appellant has not shown adequate sales to cover its costs during the liability period. This is persuasive evidence that appellant was attempting to shift revenue from a taxable category (food and alcohol sales) to a potentially nontaxable category (admission fees or services unrelated to taxable sales).

Consequently, appellant has not shown that the admission fees are nontaxable, and appellant has not met its burden to establish that a result differing from CDTFA's determination is warranted.

HOLDING

Adjustments are not warranted to the deficiency measure for unreported admission fees.

DISPOSITION

Sustain CDTFA's action denying the petition for redetermination.

Signed by:
Kim Wilson
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Kim Wilson
Hearing Officer

We concur:

Signed by:
Natasha Ralston
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Natasha Ralston
Administrative Law Judge

DocuSigned by:
Michael Geary
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Michael F. Geary
Administrative Law Judge

Date Issued: 11/12/2024