

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:)	OTA Case No.: 241118020
M. JIMENEZ,)	CDTFA Case ID: 457-459, 1-045-005
dba Fiesta Mexicana Bar & Grill)	
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OPINION

Representing the Parties:

For Appellant: Mitchell Stradford, Representative

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Crystal Spratley, Business Taxes Specialist

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 6561 and 6901, M. Jimenez (appellant) appeals a decision and supplemental 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 August 6, 2018, and denying a corresponding protective claim for refund filed by appellant. The NOD is for tax of \$396,024, plus applicable interest, and a negligence penalty of \$39,602.41 for the period October 1, 2012, through December 31, 2015 (liability period).²

Prior to this appeal, CDTFA performed a reaudit pursuant to its own supplemental decision. The reaudit reduced the tax from \$396,024 to \$376,328. During the reaudit, CDTFA also made corresponding reductions to the negligence penalty and interest.

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 CDTFA timely issued the NOD because on February 7, 2018, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period October 1, 2012, through June 30, 2015, which allowed CDTFA until October 31, 2018, to issue an NOD. (See R&TC, §§ 6487(a), 6488.)

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).

ISSUE

1. Whether further adjustments are warranted to the measure of unreported taxable bar sales based on markup of cost.³
2. Whether appellant was negligent.

FACTUAL FINDINGS

1. Appellant, a sole proprietor doing business as Fiesta Mexicana Bar & Grill, operated as a dine-in restaurant with a full bar located in South Gate, California. Appellant incorporated the business and closed out the sole proprietor seller's permit effective December 31, 2015.
2. During the liability period, appellant reported total sales of \$1,131,500 and claimed deductions for sales tax included in gross receipts of \$93,329, which resulted in reported taxable sales of \$1,038,171.
3. CDTFA performed an audit of the restaurant and the bar. However, CDTFA did not assess any additional tax on appellant's restaurant sales.⁴
4. For the audit, appellant did not provide a complete set of books and records. Instead, appellant provided the following: federal income tax returns for 2012, 2013, and 2014; monthly sales summaries for, 2013, 2014, and 2015; monthly purchase invoices for the second quarter of 2014 (2Q14) through 4Q15; daily closing z-tapes for 3Q15 and 4Q15; daily settlement reports for 3Q14, 3Q15, and 4Q15; and bank statements for the period October 2012 through September 2015.
5. Upon audit, CDTFA compared the gross receipts that appellant reported on his federal income tax returns to the total sales (excluding tax) that appellant reported on his sales and use tax returns for the period 2012 through 2014, noting differences in each year. In

³ The NOD is based on three audit items: (1) additional taxable sales based on markup method; (2) unreported mandatory tips per taxpayer sales summary report; and (3) self-consumed merchandise at two percent of adjusted bar purchases. Appellant's petition for redetermination disputes only the additional taxable sales based on the markup method. Similarly, appellant's appeal to OTA only discussed audit item 1. Therefore, OTA finds that audit items 2 and 3 are not at issue and will not discuss them further.

⁴ Because CDTFA did not assess any tax on appellant's restaurant sales, this portion of the audit is not at issue, and OTA will not discuss it further.

- total, the gross receipts that appellant reported on his federal income tax returns exceeded the taxable sales reported on his sales and use tax returns by \$2,958,122. Based on these differences, CDTFA determined that additional analysis was warranted.
6. CDTFA scheduled the total sales recorded in appellant's sales summaries for the period 2013 through 2015. CDTFA compared the sales summaries to appellant's federal income tax returns and found immaterial differences. CDTFA also compared appellant's sales summaries to appellant's sales and use tax returns for the period 4Q12⁵ through 2015. CDTFA found that the total sales (including tax and excluding tips) that appellant recorded in his sales summaries exceeded reported total sales (including tax) by \$2,877,333.
 7. CDTFA reviewed appellant's daily sales receipts to compute the ratio of appellant's food to alcohol sales for the period August 3, 2015, through August 9, 2015, and found that 31.56 percent of appellant's sales were attributable to the sale of alcohol (bar sales). CDTFA found that appellant's bar sales included regular, entertainment, and happy hour sales consisting of: 1.26 percent regular beer sales; 0.19 percent regular liquor sales; 0.45 percent regular cocktail sales; 0 percent regular wine sales; 17.04 percent entertainment beer sales; 4.57 percent entertainment liquor sales; 6.70 percent entertainment cocktail sales; 0.25 percent entertainment wine sales; 0.78 percent happy hour beer sales; 0.32 percent happy hour liquor sales; and 0 percent happy hour wine sales.
 8. CDTFA also performed a purchase segregation test by scheduling appellant's purchase invoices for September 2014.⁶ Based on this information, CDTFA calculated a bar purchase ratio of 30.29 percent.
 9. CDTFA compared the taxable sales that appellant reported on his sales and use tax returns to the purchases recorded on appellant's federal income tax returns for 2013 and 2014 to calculate markups of negative 20.65 percent for 2013 and negative 21.53 percent for 2014. CDTFA also calculated markups on food sales of negative 19.69 percent for 2013 and negative 20.58 percent for 2014. Additionally, CDTFA calculated book markups on bar sales of negative 15.64 percent for 2013 and negative

⁵ Bank statements for the period of 4Q12 were used as sales summary reports were not available.

⁶ A purchase segregation test segregates total merchandise purchases based on product category (e.g., beer, wine, carbonated beverages, tobacco products, "other" taxable merchandise, food, etc.) and/or taxability (i.e., whether a product's sale is subject to taxation or not).

- 16.57 percent for 2014. Based on the negative markups for the bar and the large discrepancies between the sales and use tax returns and federal income tax returns, CDTFA determined that further investigation was warranted
10. CDTFA performed a shelf test to calculate appellant's audited bar sales. CDTFA used appellant's purchase invoices for beer, liquor, cocktails,⁷ and wine for the month of August 2015 to calculate appellant's purchases.⁸ CDTFA then used the sales ratio results for each category in the one-week segregation test to compute a weighted average bar markup of 595.07 percent.
 11. To calculate audited bar sales, CDTFA applied the 30.29 percent bar purchase rate to the purchases reported on appellant's federal income tax returns⁹ to calculate bar purchases of \$119,974 for 2013 and \$123,405 for 2014. CDTFA reduced appellant's bar purchases to account for self-consumption, breakage, bar supplies, and bar mixes to compute audited bar purchases of \$104,825 for 2013, and \$107,822 for 2014. CDTFA applied the weighted markup factor of 695.07¹⁰ percent to appellant's audited bar purchases to calculate audited bar sales of \$728,607 for 2013, and \$749,438 for 2014.
 12. CDTFA compared the audited bar sales to the bar sales recorded in appellant's sales summaries for 2013 and 2014.¹¹ For 2013, appellant recorded bar sales of \$357,074, which when compared to audited bar sales of \$728,607 revealed unreported bar sales of \$371,533, which is an error rate of 104.05 percent ($\$371,533 \div \$357,074$). For 2014, appellant recorded bar sales of \$342,727, which when compared to audited bar sales of

⁷ The audit indicates that the "liquor" category consists of premium and call liquors used for shots and beverages served on the rocks. The "cocktail" category includes well liquors used for mixed drinks.

⁸ A shelf test compares known costs and associated sales prices to compute markups.

⁹ It appears that CDTFA used purchases recorded on appellant's federal income tax returns instead of the cost of goods sold (COGS) reported on appellant's federal income tax returns because appellant's COGS included labor costs that were not related to bar purchases.

¹⁰ A markup factor is the factor by which cost of sales is multiplied to determine total sales (cost of goods sold x markup factor = total sales); the markup factor always will be the percentage of markup plus 100 percent. In this case, the markup factor is equivalent to 100 + the markup of 595.07 percent.

¹¹ CDTFA calculated "recorded bar sales" by applying the 31.56 percent bar sales ratio determined during the one-week segregation test to the gross receipts (excluding tax) that appellant recorded in his sales summaries. For 2013, appellant recorded gross receipts (excluding tax) of \$1,131,412, which after applying the 31.56 percent bar sales ratio results in recorded bar sales of \$357,074 ($\$1,131,412 \times 0.3156$). For 2014, appellant recorded gross receipts (excluding tax) of \$1,085,953, which after applying the 31.56 percent bar sales ratio results in recorded bar sales of \$342,727 ($\$1,084,953 \times 0.3156$).

- \$749,438 for 2014 revealed a difference of \$406,711 which is an error rate of 118.67 percent ($\$406,811 \div \$342,727$).
13. CDTFA applied the error rate of 104.05 percent for 2013 to appellant's recorded bar sales for 4Q12 to calculate additional taxable sales of \$92,884. CDTFA applied the error rate of 118.67 percent for 2014 to appellant's recorded bar sales for each quarter of 2015¹² to calculate additional taxable sales of \$119,895 for 1Q15, \$150,711 for 2Q15, \$101,462 for 3Q15, and \$104,668 for 4Q15.
 14. In total, CDTFA found that appellant failed to report taxable bar sales of \$1,347,870.
 15. On August 6, 2018, CDTFA issued the NOD. In addition to the tax, CDTFA also imposed a negligence penalty based on appellant's significant reporting errors. Appellant filed a timely petition for determination and claim for refund disputing the measure of unreported taxable bar sales.
 16. CDTFA subsequently issued a May 11, 2023 decision and an April 22, 2024 supplemental decision. In the supplemental decision, CDTFA found that seafood purchases in the amount of \$2,619 were excluded from the purchase segregation test and ordered a reaudit. CDTFA otherwise denied the petition for redetermination.
 17. In the reaudit, CDTFA added the omitted seafood purchases of \$2,619, which had the effect of reducing the bar purchase ratio from 30.29 percent to 27.68 percent. CDTFA applied this amount to the purchases recorded on appellant's federal income tax returns for 2013 and 2014 to find audited bar sales of \$665,821 and \$684,859, respectively. CDTFA compared appellant's audited bar sales to the taxable sales recorded in appellant's sales summaries and found unreported taxable bar sales of \$308,747 for 2013 and unreported taxable bar sales of \$342,132 for 2014. CDTFA calculated an error rate for 2013 of 86.47 percent and applied it to appellant's recorded taxable sales for 4Q12. CDTFA also calculated an error rate for 2014 of 99.83 percent and applied it to appellant's recorded taxable sales for each quarter of 2015. In total, CDTFA reduced unreported taxable sales from \$1,347,870 to \$1,129,146.
 18. This timely appeal to OTA followed.

¹² Appellant's reported bar sales for 2015 included: \$101,032 for 1Q15; \$127,000 for 2Q15; \$85,499 for 3Q15; and \$88,201 for 4Q15.

DISCUSSION

Issue 1: Whether further adjustments are warranted to the measure of unreported taxable bar sales based on markup of cost.

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.*)

Here, when CDTFA reviewed the available books and records it found discrepancies that could not be explained. For example, the gross receipts reported on appellant's federal income tax returns exceeded total sales reported on appellant's sales and use tax returns. Similarly, the total sales recorded in appellant's sales summaries significantly exceeded the total sales reported on appellant's sales and use tax returns. Finally, a comparison of the total sales reported in appellant's sales and use tax returns to the purchases recorded on appellant's federal income tax returns yielded negative markups, meaning that appellant reported selling merchandise for less than it cost. Thus, it was reasonable for CDTFA to question the accuracy of appellant's reported total sales.

When CDTFA cannot compute taxable sales from appellant's records, it is appropriate to use an indirect method. (See *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.) To calculate taxable sales, CDTFA used a markup method based on a shelf-test, appellant's purchase records, and appellant's federal income tax returns. Specifically, CDTFA calculated the ratio of appellant's bar purchases and applied it to the total purchases that appellant reported on his

federal income tax returns. CDTFA then used the results of a weighted markup to calculate appellant's audited taxable sales. The markup method is a recognized and accepted audit procedure. (*Appeal of Amaya*, 2021-OTA-328P.) Upon reaudit, CDTFA considered new documentation and adjusted the purchases used in the purchase segregation test, which reduced the taxable measure. Thus, OTA finds that it was reasonable to use the markup method to calculate audited taxable sales, and when taking the reaudit into account, the results appear reasonable. Accordingly, the burden shifts to appellant to prove that a reduction is warranted. (See *Appeal of Talavera*, *supra*.)

On appeal, appellant asserts that the taxable measure should be reduced. Appellant argues that the audited COGS that CDTFA used to calculate taxable sales is overstated. However, as discussed, CDTFA reasonably and rationally calculated appellant's bar purchases by reviewing appellant's purchase invoices to calculate a bar purchase ratio, which CDTFA then applied to total purchases reported on appellant's federal income tax returns. Appellant has not provided any evidence to support his contention that CDTFA miscalculated appellant's bar purchases. Accordingly, OTA finds no further adjustments are warranted.

Issue 2: Whether appellant was negligent.

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)* (2015) 248 Cal.App.4th 434, 437.)

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 practices 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).)

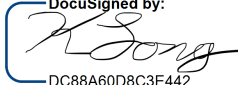
Here, appellant failed to provide a complete set of books and records for audit, which is evidence of negligence. Additionally, the audit disclosed a deficiency measure of \$1,129,146; when compared to reported bar sales of \$1,190,801 this reveals a 94 percent error rate ($\$1,129,146 \div \$1,190,801$.) This difference is significant and is evidence of negligence. Therefore, OTA finds that appellant did not exercise the care that a reasonable and prudent person would exercise under similar circumstances. Finally, OTA notes that a simple comparison of appellant's federal income tax returns and appellant's sales summaries to appellant's sales and use tax returns yielded significant differences. Thus, OTA finds that appellant could not have a good faith, reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law. Although this was appellant's first audit, OTA concludes that the negligence penalty was properly imposed and that appellant has failed to establish that it was not negligent.

HOLDINGS


1. Appellant has not shown that further adjustments to the unreported taxable sales based on markup of cost are warranted.
2. Appellant was negligent.

DISPOSITION

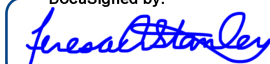
CDTFA's action is sustained.

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 Keith T. Long
 Administrative Law Judge

We concur:
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 Andrew Wong
 Administrative Law Judge

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 Teresa A. Stanley
 Administrative Law Judge

Date Issued: 2/12/2026