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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **SHADOW LOUNGE INC.,** **dba CR2 Bar & Billiards and The Den**	OTA Case No.: 250319059 CDTFA Case IDs: 5-209-301, 5-210-635, 5-204-980, 5-216-925

OPINION

Representing the Parties:

For Appellant: Mitchell Stradford, Representative

For Respondent: Jason Parker, Chief of Headquarters Ops.

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 6561 and 6901, Shadow Lounge Inc. (appellant), dba CR2 Bar & Billiards (CR2) and The Den, appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) denying appellant's timely petitions for redetermination of two Notices of Determination (NODs) issued on August 23, 2023,[1] and two protective claims for refund.[2] The first NOD is for tax of $18,194, plus applicable interest, and a negligence penalty of $1,819.35 for the period January 1, 2019, through December 31, 2021 (liability period). The second NOD is for tax of $31,557, plus applicable interest, for the liability period. The second NOD also included a negligence penalty of $1,301.38 for the period January 1, 2019, through March 31, 2021, and a penalty of $7,417.14 for knowingly collecting but not remitting sales tax reimbursement for the period April 1, 2021, through December 31, 2021.[3]

[1] CDTFA timely issued the NODs because on June 21, 2023, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period January 1, 2019, through June 30, 2020, which allowed CDTFA until October 31, 2023, to issue an NOD. (See R&TC, §§ 6487(a), 6488.)

[2] A taxpayer will sometimes file a petition for redetermination and a claim for refund to protect its right to claim a refund or credit for overpayments discovered in an audit or that may be discovered during the taxpayer's appeal of the NOD. Such claims are frequently referred to as protective claims for refund.

[3] On appeal, appellant does not raise any arguments or provide any evidence with respect to the negligence penalties or the penalty for knowingly collecting but not remitting sales tax reimbursement. Accordingly, the Office of Tax Appeals finds they are not at issue and will not discuss these penalties further.

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

Whether any adjustments to the measures of tax are warranted.[4]

FACTUAL FINDINGS

1. Appellant, a corporation, operated two bars including: CR2, located in Modesto, California, which operated throughout the liability period; and The Den, located in Winton, California, which began operations on July 1, 2021. CDTFA issued appellant's seller's permit effective March 23, 2018, and closed effective June 17, 2024. This was appellant's first audit.
2. During the liability period, appellant filed sales and use tax returns reporting total sales of $751,963 and claiming deductions of $56,036 for sales tax included in reported total sales, which resulted in taxable sales of $695,928.
3. For the audit, appellant provided the following: federal income tax returns for 2019 and 2020; bank statements for the liability period; profit and loss (P&L) statements for the liability period; point of sale (POS) reports for the audit period; POS item sales detail reports locations for May 2022; vendor purchase reports; purchase invoices from various vendors for April 2022; purchase invoices from Valley Wide Beverage for May 2022; and various purchase invoices from Southern Glazer's Wine & Spirits for both locations.
4. Appellant also completed Bar Fact Sheets identifying the pour size and prices of liquor, beer, cocktails, and wine.[5] The Bar Fact Sheets also identified appellant's self-consumption, happy hour days and times, and estimates of the percentage of appellant's happy hour and cocktail sales.
5. Upon audit, CDTFA compared the gross receipts that appellant reported on its federal income tax returns for 2019 and 2020. For 2019, the gross receipts reported on appellant's federal income tax returns exceeded the taxable sales reported on appellant's sales and use tax returns by $12,808. For 2020, the taxable sales reported

[4] The NODs are based on four audit items identifying unreported taxable sales and unreported taxable self-consumption of tangible personal property.

[5] A Bar Fact Sheet is a form published by CDTFA and completed with the input from a taxpayer that provides various information regarding the operation of a bar, such as hours of operation, selling prices, pour sizes, glass sizes, pilferage, and self-consumption.

on appellant's sales and use tax returns exceeded the gross receipts reported on appellant's federal income tax returns by $13,495.

6. CDTFA used appellant's federal returns and P&L statements to calculate book markups.[6] CDTFA reduced the gross receipts that appellant reported on its federal income tax return by the sales tax included in gross receipts, recorded tips, and gaming income, to compute adjusted gross receipts of $225,463 for 2019 and $134,933 for 2020. Next, CDTFA reduced the purchases that appellant reported on its federal income tax returns by the restaurant and bar supply purchases that appellant recorded in its P&L statements to compute adjusted purchases of $131,238 for 2019 and $62,328 for 2020. CDTFA compared the adjusted gross receipts reported on appellant's federal income tax returns to adjusted purchases to compute book markups of 67.53 percent for 2019 and 116.49 percent for 2020.
7. CDTFA also compared the taxable sales that appellant reported on its sales and use tax returns to appellant's adjusted purchases to compute markups of 104.12 percent for 2019 and 164.43 percent.
8. CDTFA used appellant's POS reports to compile recorded taxable sales of $1,100,845 for the liability period, which exceeded reported taxable sales by $404,917. CDTFA used appellant's purchase invoices to schedule audited purchases of $368,975 for the liability period. CDTFA compared the taxable sales recorded in appellant's POS reports to appellant's audited purchases to compute POS book markups of 175.47 percent for 2019, 140.68 percent for 2020, 246.49 percent for 2021, and 198.43 percent for the liability period.
9. CDTFA used appellant's P&L statements to compute a book markup for appellant's alcohol sales at the CR2 location. CDTFA compared the alcohol sales (excluding sales tax (ex-tax)) to the alcohol purchases that appellant recorded in its P&Ls to calculate a markup.[7] For CR2, CDTFA calculated P&L book markups of 78.26 percent for 2019, 146.2 percent for 2020, 68.20 percent for 2021, and 87.03 percent for the liability period.

[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 $0.70 and it charges customers $1, 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.

[7] To calculate total recorded alcohol purchases, CDTFA took the sum of appellant's alcohol purchases, beer purchases, and non-alcoholic beverage purchases. It is unclear whether appellant's recorded alcohol sales include non-alcoholic beverages. However, appellant's non-alcoholic beverage purchases are immaterial and have little effect on the calculated markup.

10. CDTFA also calculated a P&L book markup for appellant's total sales from The Den. According to the audit workpapers, The Den was initially slated to begin operations in 2020, but the opening was postponed until the third quarter of 2021 (3Q21) due to the COVID-19 pandemic. Despite this, The Den recorded sales and/or purchases for all three years of the liability period.[8] For 2020, The Den's P&L statements indicate zero sales but total purchases of $227, resulting in a 100 percent loss. For 2020, The Den P&L statements indicate ex-tax bar sales of $20,244, which when compared to recorded alcohol purchases of $16,378 resulted in a P&L book markup of 23.6 percent. For 2021, The Den recorded ex-tax bar sales of $57,459, which when compared to recorded alcohol purchases of $23,405 resulted in a P&L book markup of 145.5 percent.
11. For each computation discussed above, CDTFA considered the resulting markup to be too low for this type of business.
12. CDTFA compared appellant's bank statements to appellant's sales and use tax returns. CDTFA reduced bank deposits from sales proceeds of $926,889 by the sales tax rate to compute bank deposits (excluding sales tax) of $859,740, which exceeded reported taxable sales of $695,928 by $163,812. Appellant could not explain the discrepancy.
13. CDTFA used appellant's vendor purchase reports and P&L statements to compile audited merchandise purchases for both locations for each year of the liability period. For CR2, CDTFA found audited purchases of $311,693 for the liability period. For The Den, CDTFA found audited purchases of $57,002 for the liability period.

Taxable Measure for the CR2 location

14. CDTFA used the information contained in the Bar Fact Sheet to calculate appellant's unreported self-consumption. Appellant reported self-consumption of 295 liquor drinks per month, which CDTFA multiplied by a cost per drink of $1.51 to compute a cost per month of $446.66.[9] Appellant reported self-consumption of 70 beers per month, which CDTFA multiplied by a cost per drink of $1.65 to compute a cost per month of $115.35. CDTFA added the cost per month of liquor and beer and multiplied the result by four to calculated quarterly alcohol self-consumption of $1,685. CDTFA multiplied appellant's quarterly taxable self-consumption by the number of quarters in the liability period to

[8] Although appellant recorded purchases and sales for The Den during 2019 and 2020, the taxable measure is based solely on unreported taxable sales for 3Q21 and 4Q21.

[9] OTA notes that the product of 295 and $1.51 is $445.45 (295 × $1.51). The discrepancy appears to be the result of rounding within the audit workpapers.

compute audited taxable self-consumption of $20,220. CDTFA assessed use tax on the full amount of audited taxable self-consumption because appellant did not report any purchases subject to use tax on its returns.

15. CDTFA performed a bar shelf test to calculate weighted markups on appellant's purchases of beer and liquor.

    a. For beer, CDTFA reviewed appellant's April 2022 purchase invoices and May 2022 POS items sales detail. CDTFA scheduled each purchase and found that they consisted of 26.95 percent import, 25.48 percent domestic, and 47.56 percent draft. CDTFA compared the extended selling price to the total cost per purchase to compute appellant's profit.[10] CDTFA divided appellant's profit by the cost per unit to calculate a markup for each category, including: 396.89 percent for import; 362.6 percent for domestic; and 199.6 percent for draft. CDTFA applied the markup for each category to the percentage of total purchases in each category to calculate a weighted markup on beer of 294.28 percent.

    b. For liquor, CDTFA reviewed appellant's purchase invoices from February and March 2022 and found that appellant's purchases consisted of 7.91 percent well liquor, 6.22 percent cocktails, and 85.87 percent call/premium liquor. CDTFA compared the extended selling price[11] to the total cost per purchase to compute appellant's profit, which CDTFA then divided by the cost per unit to calculate a markup for each category, including: 764.45 percent for well liquor; 455 percent for cocktails; and 401.69 percent for call/premium liquors. CDTFA applied the markup for each category to the percentage of total purchases in each category to calculate a weighted markup on liquor of 433.72 percent.

[10] To calculate the extended selling price, CDTFA multiplied the total units purchased in any given transaction by the number of servings (glasses or bottles) per unit. CDTFA then multiplied the result by the per unit selling price as recorded in appellant's POS item sales detail. For example, if appellant purchased two cases of beer and sold each beer for $6, the extended selling price would be $288 (2 cases × 24 bottles of beer per case × $6). To compute the extended selling price of draft beer, CDTFA used the number of 16-ounce pours per keg. CDTFA used pour sizes obtained from appellant's Bar Fact Sheet.

[11] For this test, CDTFA calculated the extended selling price by multiplying the number of bottles purchased by the number of drinks per bottle by each drink's selling price. For example, if appellant purchased six bottles and each bottle produced 14.88 drinks at $6 per drink, the extended selling price would be $535.68 (6 bottles × 14.88 drinks per bottle × $6). CDTFA used 1.5 ounce pours for well, call, and premium liquors, as stated in appellant's Bar Fact Sheet. CDTFA used 2.25 ounce pours for cocktails, also as stated in appellant's Bar Fact Sheet.

16. CDTFA segregated appellant's audited purchases for CR2 of $311,693 for the liability period and found that appellant purchased $183,068 of beer (58.63 percent of purchases) and $128,625 of liquor (41.27 percent of purchases). CDTFA applied each category's percentage of cost of sales to the results of the bar shelf test to calculate a weighted markup on beer of 172.83 percent, a weighted markup on liquor of 179 percent, and a combined weighted markup of 351.83 percent.
17. To calculate an allowance for happy hour and other discounts, CDTFA used appellant's POS reports to compare recorded happy hour discounts with recorded taxable sales before happy hour discounts. For 2019, CDTFA found a discount rate of 5.38 percent. For 2020, CDTFA found a discount rate of 3.19 percent. For 2021, CDTFA found a discount rate of 8.22 percent.
18. CDTFA computed the measure of unreported taxable sales for CR2 as follows. First, CDTFA reduced audited purchases by audited self-consumption and a two percent allowance for pilferage to find audited taxable cost of goods sold (COGS) of $285,644 for the liability period. CDTFA then applied the taxable weighted markup factor of 4.5183 to compute audited taxable sales of $1,290,625. CDTFA reduced audited taxable sales by happy hour and other special discounts of $79,994 and the sales tax rate to compute audited ex-tax taxable sales net happy hour and other specials discounts of $1,122,253, which when compared to reported taxable sales of $970,392 revealed a difference of $151,861.

Taxable Measure for The Den

19. CDTFA used the information provided on appellant's Bar Fact Sheet for CR2 to compute appellant's unreported self-consumption subject to use tax.[12] As discussed above, CDTFA computed self-consumption of $1,685 dollars per quarter, which CDTFA applied to 3Q21 and 4Q21. In total, CDTFA concluded that appellant had unreported self-consumption subject to use tax at The Den of $3,370 ($1,685 × 2) for the liability period.
20. CDTFA performed a bar shelf test to calculate markups on appellant's purchases of beer and liquor.
    a. For beer, CDTFA reviewed appellant's purchase invoices for April through May 2022. CDTFA scheduled each purchase and found that they consisted of

[12] Appellant's Bar Fact Sheet for The Den stated that appellant did not report use tax on self-consumption.

43.56 percent import, 22.57 percent domestic, and 33.87 percent draft. CDTFA compared the extended selling price to the total cost per purchase to compute appellant's profit. CDTFA divided appellant's profit by the cost per unit to calculate a markup for each category, including: 313.86 percent for import; 358.09 percent for domestic; and 193.43 percent for draft. CDTFA applied the markup for each category to the percentage of total purchases in each category to calculate a weighted markup on beer of 283.05 percent.

b. For liquor, CDTFA reviewed appellant's purchase invoices from February 2022, and March 2022, and found that appellant's purchases consisted of 7.67 percent well liquor, 6.89 percent cocktails, and 85.44 percent call/premium liquor. CDTFA compared the extended selling price to the total cost per purchase to compute appellant's profit, which CDTFA then divided by the cost per unit to calculate a markup for each category, including: 917.81 percent for well liquor; 697.39 percent for cocktails; and 319.33 percent for call/premium liquors. CDTFA applied the markup for each category to the percentage of total purchases in each category to calculate a weighted markup on liquor of 391.29 percent.

21. CDTFA segregated appellant's audited purchases for The Den of $57,182 for the liability period and found that appellant purchased $42,952 of beer (75.11 percent of purchases) and $14,230 of liquor (24.89 percent of purchases). CDTFA applied each category's percentage of cost of sales to the results of the bar shelf test to calculate a weighted markup on beer of 212.6 percent, a weighted markup on liquor of 97.39 percent, and a combined weighted markup of 309.99 percent.

22. To calculate an allowance for happy hour and other discounts, CDTFA used appellant's POS reports to compare recorded happy hour discounts of $15,263 with recorded taxable sales before happy hour discounts of $140,940, which revealed a discount rate of 10.93 percent.

23. CDTFA calculated the measure of unreported taxable sales for The Den as follows. First, CDTFA reduced audited purchases by audited self-consumption and a two percent allowance for pilferage to find audited taxable COGS of $52,644 for the liability period. CDTFA then applied the taxable weighted markup factor of 4.099 to compute audited taxable sales of $216,213. CDTFA reduced audited taxable sales by happy hour and other special discounts of $23,416 and the sales tax rate to compute audited ex-tax

taxable sales net happy hour and other specials discounts of $178,930, which when compared to reported taxable sales of $127,700 revealed a difference of $51,230.

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*.)

Here, CDTFA compared the gross receipts reported on appellant's federal income tax returns to the taxable sales reported on appellant's sales and use tax returns and found immaterial differences. However, the sales recorded in appellant's POS reports exceeded reported taxable sales by $404,917. Additionally, a review of appellant's bank statements revealed that bank deposits exceeded reported taxable sales by $163,812. Next, CDTFA's markup computations revealed markups that it considered too low for this type of business. Specifically, CDTFA used appellant's federal income tax returns, POS reports, purchase invoices, and P&L reports to calculate markups in a variety of ways. In each case, CDTFA considered the markup rates low for this type of business. OTA also notes that the computed markups are inconsistent from method to method and from year to year. For example, appellant's book markups varied by nearly 60 percent between 2019 and 2020 from a book markup of 67.53 percent to 116.49 percent. Similarly, appellant's P&L book markups varied by nearly 50 percent in each year of the liability period. Considering these inconsistencies and

unexplained discrepancies, it was reasonable and rational for CDTFA to determine that further examination was warranted.

When CDTFA cannot compute taxable sales from appellant's records, it is appropriate to use an indirect method. (See *Appeal of Las Playas # 19, Inc.*, 2021-OTA-204P.) To calculate the taxable measure, CDTFA used appellant's purchase invoices and the information provided in the Bar Fact Sheet to calculate a markup of costs for CR2 and The Den. CDTFA also reduced the taxable measure to account for pilferage, and discounts. The markup method is a recognized and accepted accounting procedure. (*Appeal of Amaya*, 2021-OTA-328P.) Next, CDTFA used information disclosed by appellant on the Bar Fact Sheets to determine the measure of unreported use tax on appellant's self-consumption. Considering the foregoing, OTA finds that CDTFA's use of the markup method, and other information obtained from appellant, to calculate the audit liability was reasonable and rational. Accordingly, the burden of proof shifts to appellant to show that adjustments are warranted.

On appeal, appellant contends that the taxable measure should be reduced. Appellant argues that the audit did not account for warranted adjustments including higher liquor pour size, additional self-consumption, sales of draft beer in mugs with a lower markup, and the incorrect inclusion of keg deposit amounts in the purchase prices. Appellant argues that after taking these proposed adjustments into account, appellant's reporting error rates are sufficiently low as to support a finding that its POS records are accurate. Therefore, appellant argues that the markup computation does not represent actual additional unreported taxable sales.

However, appellant does not provide any evidence or calculations for the proposed adjustments. There is nothing in the record to suggest a higher liquor pour size or lower draft beer markups. Instead, the available evidence shows that CDTFA used information provided by appellant in determining the pour size of liquor and beer, as well as appellant's self-consumption. As found above, CDTFA's determination is both reasonable and rational. Appellant's unsupported assertions are insufficient to carry its burden of proof. (*Appeal of Talavera*, *supra*.) Accordingly, OTA finds that no adjustments are warranted.

HOLDING

No adjustments to the measures of tax are warranted.

DISPOSITION

CDTFA's action is sustained.

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Keith T. Long
Administrative Law Judge

We concur:

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Susana Seyller
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Susana Seyller
Acting Supervisor, on behalf of
Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:
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Teresa A. Stanley
Administrative Law Judge

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