STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	
JAMES PAUL FLORES & LYDIA PIMENTEL FLORES dba Café Estela	Account Number: SR FH 99-830472 Case ID 585502
Petitioner	National City, San Diego County

Type of Business: Restaurant

Audit period: 07/01/05 – 12/31/09

Item	Disputed Amount
Unreported taxable sales	$609,422
Fraud penalty	$ 14,407

	Tax	Penalty
As determined	$68,838.00	$17,209.52
Post-D&R adjustments	- 11,208.86	- 2,802.19
Proposed redetermination	$57,629.14	$14,407.33
Less concurred	- 5,040.72	00.00
Balance protested	$52,588.42	$14,407.33

Proposed tax redetermination	$ 57,629.14
Interest through 08/31/15	31,327.36
Fraud penalty	14,407.33
Total tax, interest, and penalties	$103,363.83
Monthly interest beginning 09/01/15	$ 288.15

This matter was scheduled for Board hearing in February 2014, but was postponed for settlement consideration.

UNRESOLVED ISSUES

Issue 1: Whether additional adjustments to the amount of unreported taxable sales are warranted. We conclude that no further adjustments are warranted.

Petitioner has operated a beer bar and restaurant serving Mexican-style food since January 1996. One of petitioner's co-owners, James Paul Flores, operated the business as a sole proprietorship from June 1973 through December 1995. For audit, petitioner provided copies of its federal income

tax returns (FITR's), sales and use tax returns, and daily cash register z-tapes and merchandise purchase invoices for the period January 1, 2007, through June 30, 2007. The Sales and Use Tax Department (Department) found that the gross receipts reported on petitioner's FITR's for the years 2005, 2006, and 2007 exceeded the total sales reported on the sales and use tax returns for the same years by $20,586. The Department then compared the gross receipts with the costs of goods sold reported on the FITR's and calculated a book markup of 20.13 percent, which was much lower than the book markup of at least 200 percent that the Department expected for this type of business. The Department asked petitioner to record each sale for a two-week period in March 2009. However, petitioner only provided the sales records that the Department requested for one day during the test period, March 20, 2009, a Friday, which was the day that the Department observed petitioner's operations. In the absence of complete, reliable records, the Department decided to rely on the recorded sales for the test day as the basis for establishing audited taxable sales for the audit period.

During its observation, the Department noted that petitioner's cash register was programmed to add sales tax reimbursement to sales of hot prepared food for consumption on the premises, but not to sales of beverages. After the Department also observed that petitioner did not ring up happy hour beverage sales at the time of the sale, the Department kept a tally of the beverages sold on March 20, 2009, and computed taxable beverage sales of $112 during happy hour. Adding happy hour beverage sales of $112 to petitioner's other recorded sales of $603.72 for that day resulted in daily recorded sales of $715.72, including sales tax reimbursement. Using this daily total, the Department established audited quarterly sales of $64,414.80, including sales tax reimbursement ($715.72 x 90 days), which exceeded petitioner's average quarterly reported sales of $19,502.00 by $44,912.80, representing an error rate of 230.30 percent. The Department multiplied petitioner's reported total sales for each quarter by the error rate of 230.30 percent to establish unreported taxable sales of $808,430, including sales tax reimbursement, for the audit period. Based on petitioner's assertion that the business was not open 90 days per quarter because it was closed on Sundays, we recommended that audited sales be recomputed based on the actual number of days each quarter, excluding Sundays. Following adjustments to exclude sales tax reimbursement, the post-D&R reaudit resulted in an understatement of

audited taxable sales of $660,499. Petitioner has computed an understatement of $51,077, and disputes the remaining $609,422.

At the appeals conference, petitioner provided cash register z-tapes showing taxable sales of $378,952, and contends that these z-tapes accurately reflect its taxable sales for the audit period. Petitioner argues that total sales of $715.72 for the test day are not representative of its sales, generally.

Based on sequential control numbers at the top of each of petitioner's z-tapes, we determined that petitioner failed to provide a substantial number of its z-tapes. For example, for the year 2009, petitioner only provided 468 of 1,277 z-tapes, with 809 z-tapes missing. Therefore, we recommend no adjustment based on the z-tapes. Further, we have computed a markup of 238 percent using the audited taxable sales for the years 2006 and 2007 of $438,109 and the purchases of $129,734 reported on petitioner's FITR's for those years. As stated previously, we would expect the markup for a restaurant selling beer to be in excess of 200 percent, and we find that a markup of 238 percent is reasonable. In addition, we note that audited daily sales of $715.72 are significantly less than audited daily sales of $847.55 established in the prior audit for the period October 1, 1997, through September 30, 2001, and conclude that audited daily sales of $715.72 are reasonable, if not conservative. Thus, we find no further adjustments are warranted.

Issue 2: Whether there is clear and convincing evidence to support the assertion of a penalty for fraud or intent to evade the tax.[1] We conclude that there is and that the penalty is applicable.

The Department imposed a 25-percent fraud penalty based on its findings that the understatement is very large in relation to reported amounts and occurred in every quarter of the audit period, petitioner had knowledge regarding its reporting responsibilities, petitioner failed to maintain or provide books and records suitable for sales and use tax reporting or auditing, and the substantial discrepancies in this audit cannot be explained satisfactorily as being due to negligence.

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[1] The Notice of Determination (NOD) was timely issued under the normal three-year statute of limitations because, on April 4, 2011, petitioner signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations. (Rev. & Tax. Code, §§ 6487, subd. (a), 6488.)

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SALES AND USE TAX APPEAL

Petitioner contends that the z-tapes showing taxable sales of $378,952 that it provided at the appeals conference accurately reflect its sales, and that the relatively minor difference of $51,077 between these recorded taxable sales and its reported taxable sales is not due to fraud.

Based on our review of the prior audit work papers for the period October 1, 1997, through March 31, 2001, we note that petitioner not only failed to retain z-tapes or any other records of its daily sales for that period, but also underreported its taxable sales by a substantial amount, which resulted in the imposition of a fraud penalty. As a result of the prior audit, we find that petitioner knew or should have known of the requirements to retain adequate sales records and report its sales accurately. However, despite such knowledge, petitioner failed to retain and provide all of its z-tapes or any other records of its daily sales. Moreover, a comparison of unreported taxable sales of $660,499 with reported taxable sales of $327,875 shows a reporting error rate of 201.45 percent. Combined with petitioner's knowledge of its sales and use tax reporting obligations and requirements to retain sales records, we find that the magnitude of this error rate constitutes evidence of fraud or an intent to evade the tax. Also, while petitioner argues that the fraud penalty should not apply because the z-tapes it provided support an understatement of $51,077, petitioner did not provide all of its z-tapes. Given that an understatement is shown even when a substantial number of z-tapes are missing, we find that petitioner must have known that its reported sales were substantially understated. In summary, we find that there is clear and convincing evidence of fraud and the penalty is warranted.

OTHER MATTERS

None.

Summary prepared by Deborah A. Cumins, Business Taxes Specialist III

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