STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matters of the Petition for Redetermination and Claim for Refund Under the Sales and Use Tax Law of: MICHAEL J. KYALWAZI, dba Café Le Monde Petitioner	Account Number SR X KH 100-198617 Case ID's 572746, 727786 Sacramento, Sacramento County

Type of Business: Restaurants

Audit period: 04/01/07 – 03/31/10

Item	Disputed Amount
Unreported taxable sales (McClellan location)	$101,158
Unreported taxable sales (Sacramento location)	$ 41,796
Difference between recorded and reported sales	$ 2,699

	Tax	Penalty
As determined	$11,973.93	$1,197.43
Post-D&R adjustment	- 444.19	- 1,197.43
Proposed redetermination, protested	$11,529.74	$ 00.00

Proposed tax redetermination	$11,529.74
Interest through 04/30/14	5,298.95
Total tax and interest	$16,828.69
Payments	- 53.79
Balance	$16,774.90

Monthly interest beginning 05/01/15	$ 57.38

This matter was scheduled for Board hearing in November 2014, but was postponed at petitioner's request due to family conflicts. The matter was then scheduled for Board hearing in March 2015, but petitioner did not respond to the Notice of Hearing, and the matter was scheduled for decision on the nonappearance calendar. Petitioner subsequently filed a late response to the hearing notice, and the matter has been rescheduled.

UNRESOLVED ISSUE

Issue: Whether any additional adjustments are warranted to the amounts of unreported taxable sales at either of petitioner's locations or to the amount established for the difference between recorded and reported taxable sales. We conclude that no additional adjustments are warranted.

Petitioner began operating a restaurant in July 2003, and operated two restaurants during the audit period. One of the restaurants (the Sacramento location) has seating for eight inside and seating for four outside, while the other restaurant (the McClellan location) has a full kitchen and seating for 50 customers. For audit, petitioner provided his federal income tax returns for 2007 and 2008, and sales summary worksheets, cash register Z-tapes, and purchase invoices for the McClellan location, but provided no source documents for the Sacramento location. The Sales and Use Tax Department (Department) found that the gross receipts reported on petitioner's income tax returns for 2007 and 2008 exceeded the total sales reported on his sales and use tax returns by substantial amounts. A comparison of the total sales reported on petitioner's sales and use tax returns with the costs of goods sold reported on his income tax returns showed a book markup of 62.51 percent for both years combined, which was significantly lower than expected. The Department then examined petitioner's sales summary worksheets, and found that petitioner reported his recorded sales for the McClellan location on his sales and use tax returns for the audit period, but did not report his sales for the Sacramento location.

The Department conducted two observation tests at the Sacramento location to determine petitioner's average daily sales at that location and the ratio of taxable sales to total sales. Results of the tests showed average daily sales of $173, and taxable sales ratios of 41.44 percent on Wednesday, June 30, 2010, 24.21 percent on Tuesday, July 13, 2010, and 32.04 percent for both days combined. Based on an average of 21 days per month that the Sacramento location was open for business, the Department computed monthly total sales of $3,624 and total sales of $130,467 for the audit period. The Department then applied the taxable sales ratio of 32.04 percent to audited total sales of $130,467 to establish audited (and unreported) taxable sales of $41,796.

For the McClellan location, the Department scheduled recorded taxable sales for the period January 1, 2008, through March 31, 2010, from petitioner's cash register Z-tapes. A comparison of recorded taxable sales with reported taxable sales for that period showed a difference of $2,699, which the Department established as the difference between recorded and reported taxable sales.

The Department found that petitioner deposited his sales receipts from both locations into one bank account, and decided to use the bank deposits to compute petitioner's total sales. The

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Department compiled total deposits of $1,377,927 for the audit period, and then added cash payouts of $49,005, subtracted $30,510 for non-business deposits, and subtracted $51,062 for documented sales to the U.S. Government, to compute audited total sales of $1,345,360 for both locations combined in the original audit. However, based on additional documentation that petitioner provided on appeal, audited total sales were further reduced by $7,750 for additional non-business deposits, and by $4,724 for four additional documented sales to the U.S. Government in a post-D&R reaudit. Subtracting audited total sales of $130,467 for the Sacramento location resulted in audited total sales of $1,202,419 for the McClellan location in the reaudit. The Department used the reported taxable and total sales for the McClellan location to compute a reported taxable sales ratio of 44.67 percent, which it applied to audited total sales for the McClellan location to establish audited taxable sales of $537,131 for that location. The Department then subtracted petitioner's reported taxable sales and the difference between recorded and reported taxable sales of $2,699 already established as a separate audit item to establish unreported taxable sales of $101,158 for the McClellan location in the reaudit. In summary, the Department computed $145,653 in unreported taxable sales, comprised of $41,796 for the Sacramento location, $101,158 for the McClellan location, and $2,699 for the difference between recorded and reported taxable sales.

Regarding the amounts used to establish unreported taxable sales of $41,796 for the Sacramento location, petitioner contends that the two–day observation test did not accurately reflect his business operations during the audit period. According to petitioner, his daily sales at that location average $110, not $173, and his taxable sales ratio is 20 percent, not 32.04 percent. Petitioner also contends that audited total sales for the McClellan location should be further reduced to allow for additional non-business deposits and exempt sales to the U.S. Government.

We find that petitioner failed to provide documentation to support his contention that his average daily sales at the Sacramento location were lower than the average daily sales observed by the Department during the two-day observation test, and we note that further testing is not possible because petitioner closed that location. Further, we note that reducing audited total sales for the Sacramento location would result in an increase to audited total sales for the McClellan location, which likely would be detrimental to petitioner because the audited taxable sales ratio for the McClellan

location is higher than the ratio for the Sacramento location. Petitioner also failed to provide documentation to support his contention that the audited taxable sales ratio should be reduced. We have reviewed the audit procedures and computations, and conclude that no adjustments are warranted.

RESOLVED ISSUE

The Department imposed a 10-percent penalty for negligence because the understatement in reported taxable sales is significant and because petitioner reported no sales from his Sacramento location. Petitioner claimed that he thought that all of his sales at the Sacramento location were exempt because most were sales of cold food, and he was unaware that having tables in the building would cause tax to apply to some of his sales of cold food. We computed that petitioner's sales of hot food at the Sacramento location totaled $17,805, and find that petitioner has no excuse for his failure to report these sales because he knew that sales of hot food were subject to tax. However, we find that petitioner's failure to report taxable sales of cold food for "dine-in" of $23,991 at the Sacramento location was the result of a misunderstanding of the law. Additionally, we find that petitioner's failure to properly document all of his claimed exempt sales to the U.S. Government was due to inexperience, since this was his first audit. After we subtracted the portion of the understatement that we found was due to a misunderstanding of the law or inexperience, we concluded that the remainder of the understatement was not large enough to constitute evidence of negligence in reporting in a first-time audit. Although petitioner's lack of books and records concerned us, we recommended that the negligence penalty be deleted.

OTHER MATTERS

The comparison between recorded and reported taxable sales in the audit showed that reported taxable sales for the fourth quarter of 2008 (4Q08) exceeded recorded taxable sales for that quarter by $634. On August 13, 2010, petitioner filed a claim for refund of overpayments due to clerical errors in preparing his returns (Case ID 727786). We find that the claim for refund of overreported tax for 4Q08 effectively was granted because the overpayment was offset against the other tax deficiencies.

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

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