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: PHILIP ANDRES ANACKER, MAURA STANLEY HARRINGTON, and JAKE ANTHONY WHITELEY, dba Flying Goat Coffee Petitioner	Account Number SR JH 97-131851 Case ID 611322 Santa Rosa, Sonoma County

Type of Business: Coffee house

Audit period: 07/01/07 – 06/30/10

Item	Disputed Amount
Unreported taxable sales	$197,259

Tax, as determined and protested	$16,795.44[1]
Interest through 2/29/16	7,286.81
Total tax and interest	$24,082.25
Payments	- 8,000.00
Balance due	$16,082.25
Monthly interest beginning 3/1/16	$ 43.98

This matter was scheduled for Board hearing in February 2015, but it was postponed for settlement consideration.

UNRESOLVED ISSUE

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

Petitioner has operated a coffee house with a substantial amount of indoor seating and outdoor seating since November 1997. For audit, petitioner provided its federal income tax returns, annual and quarterly profit and loss statements, point-of-sale (POS) system reports, purchase invoices, fixed asset schedules, and sales and use tax return worksheets. The Sales and Use Tax Department (Department)

[1] The tax is computed on a total deficiency measure of $196,034 (net of credit measure of $3,925 for a difference between recorded and reported taxable sales). Thus, if petitioner were to prevail in this appeal, the result would be an overpayment, which would be available to refund because petitioner has timely filed a claim for refund.

found that the records petitioner provided were complete, but it questioned the accuracy of the records because a comparison of petitioner's recorded taxable sales with its recorded total coffee shop sales showed a recorded taxable sales ratio of 11 percent, which was lower than the Department expected. The Department also observed that petitioner's staff erroneously rang up taxable "to-go" sales of soda as exempt, and erroneously rang up taxable sales of coffee for consumption on the premises as exempt when the coffee was served in the customers' own cups. Thus, the Department decided to perform site observation tests to establish an audited taxable sales ratio for use in computing audited taxable sales.

The Department observed petitioner's operations on Tuesday, August 31, 2010, and on Thursday, March 3, 2011. While petitioner's records showed an average taxable sales ratio of 21.30 percent for both test days combined, the Department's observations showed an average taxable sales ratio of 32.95 percent for both days combined. However, during the observation tests, the Department had recorded all sales of items that were consumed on the premises as taxable transactions even though the customers might have stated that the purchased items were "to go." Therefore, to allow for possible errors in the results of its observation tests, the Department used the lower taxable sales ratio of 21.30 percent computed from petitioner's records for the test days. Multiplying petitioner's recorded total sales of $1,896,469 for the audit period by 21.30 percent resulted in audited taxable sales of $403,948, which exceeded petitioner's recorded taxable sales by $197,259. [2]

As an additional analysis, the Department reviewed petitioner's recorded sales for six months in 2010 to test the variability of petitioner's recorded taxable sales ratios per day. The Department calculated recorded taxable sales ratios per day ranging from 1.14 percent to 22.38 percent, averaging 9.68 percent per day, with recorded taxable sales ratios of 10 percent or less on 102 days out of the 181 analyzed days. However, since the recorded taxable sales ratios were inconsistent with the results of the two-day observation test, and were inconsistent with the Department's random observations of petitioner's business at various times of day, the Department concluded that petitioner had failed to properly record many of its taxable sales.

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[2] The Department also established a credit difference between recorded and reported taxable sales of $3,925 as a separate item in the audit.

Petitioner asserts that its recorded taxable sales for the audit period are accurate, and contends that the results of the observation tests are not representative of its normal operations. Since the Department examined its records for only 180 days out of 1,080 days in the audit period, petitioner argues that the Department has not established that its recorded taxable sales amounts are inconsistent with the observation test results. Additionally, petitioner contends that the Department's alleged random observations are mere spot tests and should not be used to support the audit findings, and argues that the Department could have made errors in observation tests of similar businesses, and therefore, should not rely on its experience in auditing similar businesses for determining whether petitioner's recorded taxable sales ratios are reasonable.

We find that the Department was justified in establishing audited taxable sales based on the results of an observation test because the Department observed several instances in which petitioner's employees erroneously rang up taxable sales as exempt, which reasonably led to a conclusion that petitioner's recorded sales were inaccurate. We also find that the inconsistency shown between petitioner's daily recorded taxable sales ratios for six months and the results of the observation tests supports the conclusion that petitioner's recorded taxable sales were inaccurate. Further, we find that disregarding the Department's random observations or speculating about potential errors in observation tests of similar businesses would not alter our conclusion that petitioner's recorded taxable sales were inaccurate. We note that the Department offered to expand the observation tests to ensure that the results of the tests accurately reflected petitioner's normal operations, but petitioner consistently and adamantly refused to allow another observation test. In the absence of any evidence showing errors in computing the audited taxable sales ratio from petitioner's recorded sales on the two days of the observation tests, or evidence that the results of the tests are not representative of petitioner's sales throughout the audit period, we conclude that no adjustments are warranted.

RESOLVED ISSUES

The Department also established a credit difference between recorded and reported taxable measure of $3,925, unreported taxable sales of fixed assets of $895, and unreported purchases of fixed assets subject to use tax of $1,805. Petitioner conceded these audit items at the appeals conference.

OTHER MATTERS

None.

Summary prepared by Lisa Burke, Business Taxes Specialist III