

**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: )  
RODOLFO DAGOBERTO CARRANZA, ) Account Number SR BH 100-009203  
dba Flamingos Night Club ) Case ID 623951  
Petitioner ) Redwood City, San Mateo County

Type of Business: Night club

Audit period: 01/01/09 – 12/31/11

<u>Item</u>	<u>Disputed Amount</u>
Unreported taxable sales	\$504,394
Negligence penalty	\$ 4,529
Proposed tax redetermination, protested	\$45,287.07
Interest through 08/31/16	16,814.16
Negligence penalty	<u>4,528.76</u>
Total tax, interest, and penalty	<u>\$66,629.99</u>
Monthly interest beginning 09/01/16	<u>\$ 226.44</u>

This matter was scheduled for Board hearing in November 2014, but was deferred at the request of the Business Tax and Fee Department (Department), formerly the Sales and Use Tax Department, for further review. No additional adjustments are recommended as a result of that review, as explained under "Other Matters." This matter was rescheduled for hearing in July 2015, but was postponed for settlement consideration. It was rescheduled for hearing in May 2016, but was postponed at petitioner's request to allow additional time to prepare.

**UNRESOLVED ISSUES**

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

Petitioner operated a night club from January 2002 through December 2011, when petitioner closed out his seller's permit. For audit, petitioner provided a handwritten ledger book with some sales amounts listed, and a few bank statements. The Department researched the Internet, and found that petitioner sold a variety of cocktails, martinis, vodka drinks, scotch, and tequila from a full liquor bar,

1 and also maintained a second bar from which he sold imported and domestic beer. The Department's  
2 research also showed that petitioner offered live international music and floor space for dancing, and  
3 was open four nights and one day per week.

4 The Department obtained copies of petitioner's federal income tax returns for 2008 and 2009  
5 from the Internal Revenue Service, and found that the gross receipts of \$104,000 and \$102,000  
6 reported on the returns substantially exceeded the total sales reported on petitioner's sales and use tax  
7 returns. Petitioner attributed the differences to cover charges and income from subleasing restaurant  
8 space that he included in his reported gross receipts on income tax returns but excluded from amounts  
9 reported for sales and use tax purposes. The Department considered preparing a markup analysis to  
10 establish audited taxable sales, but petitioner did not report his costs of goods sold on his income tax  
11 returns and the Department was unable to identify petitioner's major suppliers in order to request  
12 information from them regarding petitioner's purchases. In the absence of documentation or other  
13 evidence showing petitioner's sales, the Department estimated that petitioner's annual taxable sales  
14 were double the amount of his reported gross receipts of \$102,000 for 2009, or \$204,000 per year. A  
15 comparison of audited taxable sales of \$612,000 ( $\$204,000 \times 3$  years) with petitioner's reported  
16 taxable sales of \$107,606 for the audit period shows unreported taxable sales of \$504,394.

17 Petitioner contends that the audit is based on inaccurate and biased information. According to  
18 petitioner the business was open four nights a week in 2009, but was only open two nights a week in  
19 2010, and one night a week in 2011. Petitioner alleges that he was losing money and, although he was  
20 able to employ up to four waitresses in 2009, by 2010 and 2011, only immediate family members  
21 worked at the club. Petitioner states that the entertainers who performed almost every night the club  
22 was open were paid through ticket sales, and they provided bartenders, waiters, waitresses, and  
23 security guards, because petitioner could not afford to hire any additional staff. Petitioner alleges that  
24 he had to negotiate with his landlord to reduce his monthly rent from \$9,000 in 2009 to \$7,000 in 2010,  
25 and to \$5,000 in 2011, but he ended up paying whatever he could pay in 2011, and eventually was  
26 evicted. Petitioner states that, when he was evicted, he donated his remaining bar inventory to an  
27 organization that trains waiters and bartenders, but before he had a chance to remove his equipment  
28 and furniture, the landlord discarded both of his cash registers and his desk that contained his business

1 records. Petitioner provided copies of his income tax returns for 2010 and 2011, which show reported  
2 gross receipts of \$185,000 and \$75,741, but he asserts that his reported gross receipts include receipts  
3 from ticket sales, cover charges, and rental income of \$3,000 per month for subleasing the restaurant  
4 space adjacent to his club.

5 We note that, overall, petitioner's reported gross receipts and reported total sales increased,  
6 rather than declined, from 2009 to 2010. In the absence of any evidence to support petitioner's  
7 assertion that he reduced the number of nights the nightclub was open from four nights per week in  
8 2009 to two nights per week in 2010, we find that the nightclub was open four nights per week, or 52  
9 nights per quarter (4 nights per week x 13 weeks per quarter) during the audit period.<sup>1</sup> We compute  
10 that petitioner reported average nightly bar sales ranging from \$144.17 for the second quarter of 2009  
11 to \$344.23 for the first quarter of 2011, which seems unreasonably low for a nightclub that has a  
12 capacity of 400 persons, 48 tables with two chairs per table, a dance floor, and 100-200 parking  
13 spaces<sup>2</sup> in a parking lot across the street. Based on petitioner's statement that he paid entertainers  
14 between \$400 (local bands) and \$2,000 (internationally renowned artists), and collected a cover charge  
15 of \$5.00 to \$20.00 per person, we estimate that petitioner must have drawn at least 80 patrons ( $\$400 \div$   
16  $\$5.00$  per person) to 100 patrons ( $\$2,000 \div \$20.00$  per person) each night just to pay for the cost of the  
17 entertainment. As a conservative estimate, we find that an average of 100 patrons per night purchased  
18 drinks from petitioner. Based on our experience, we find that drinks sold in nightclubs providing  
19 entertainment generally sell for between \$5.00 and \$10.00, and we find it is reasonable to presume that  
20 nightclub patrons would each consume at least two drinks. Accordingly, we estimate that each patron  
21 purchased \$10.00 worth of drinks, on average, during an evening. Based on these estimates, we  
22 calculate that petitioner generated total sales from bar operations of at least \$52,000 per quarter (100  
23 patrons  $\times$  \$10 purchase per patron  $\times$  52 nights open per quarter). Therefore, we find that audited  
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26 <sup>1</sup> Although the Department found evidence on the Internet that the business also was open on Thursdays from 9:00 a.m. to  
27 5:00 p.m., we find that it is unlikely that it was open during those hours.

28 <sup>2</sup> In its post-D&R review, the Department revised its estimate of the number of spaces in the parking lot across the street  
from 200 spaces to 100-150 parking spaces. That revision does not impact our analysis.

1 taxable sales of \$204,000 per year, or \$51,000 per quarter, is reasonable, and conclude that no  
2 adjustments are warranted.

3 **Issue 2:** Whether petitioner was negligent. We conclude that he was.

4 The Department imposed the 10-percent penalty for negligence because petitioner failed to  
5 provide any records to support his reported sales amounts, and because the understatement is  
6 substantial. Petitioner generally contends that the penalty is not warranted.

7 Petitioner failed to provide any source documents showing his sales, such as cash register  
8 z-tapes, and his method of reporting his sales is unknown. A comparison of unreported taxable sales  
9 of \$504,394 with petitioner's reported taxable sales of \$107,606 shows a reporting error rate of  
10 468.74 percent. We find that the magnitude of the error rate is substantial evidence of negligence in  
11 reporting. Although petitioner never provided cash register z-tapes for examination, at one point, he  
12 indicated to the Department that his z-tapes for 2008 were available, which conflicts with his statement  
13 to us that his business records are not available because his landlord discarded his desk with his  
14 business records in it. We find that petitioner failed to maintain records as a reasonable and prudent  
15 businessperson would, which is evidence of negligence in recordkeeping. We conclude that  
16 petitioner's bookkeeping and reporting errors (the absence of records and the magnitude of the  
17 understatement) cannot be attributed to petitioner's bona fide and reasonable belief that his  
18 bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales  
19 and Use Tax Law. Under such circumstances, the imposition of a negligence penalty in a first-time  
20 audit is appropriate. (*Cf. Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167  
21 Cal.App.2d 318, 321-324.) Accordingly, we find that the negligence penalty was properly applied,  
22 even though petitioner had not been audited previously.

### 23 **OTHER MATTERS**

24 As noted previously, when it was preparing this matter for the previously-scheduled Board  
25 hearing, the Department concluded that further review was necessary to corroborate audited sales,  
26 which are based wholly on estimates because of the complete lack of records. Although there is an  
27 analysis in the D&R that finds the audited amounts are reasonable, the Department had specific  
28 questions regarding the comments in the audit workpapers. For example, the Department requested

1 more specific information regarding the workpaper comments that: 1) there was a parking lot across  
2 the street; and 2) the club did not use a cash register. In response, the District Office staff stated that:  
3 1) the parking lot belongs to Grocery Outlet, and there are about 100-150 parking spaces, rather than  
4 the 200 spaces previously estimated; and 2) the workpapers should have stated that the register tapes  
5 were not provided to the auditor, rather than stating that no cash register was used. The Department  
6 also conducted additional review and analysis of the audit findings. However, since the available  
7 records and documentation were extremely limited, the Department relied on the analysis in the D&R  
8 to conclude that no further adjustments are warranted.

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Summary prepared by Gary A. Lomazzi, Business Taxes Specialist II