

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 CLUB HABANOS, INC.) Account Number: SR KHO 97-300595
) Case ID 426183
 6 Petitioner) Fresno, Fresno County

7 Type of Business: Bar and cigar lounge

8 Audit period: 07/01/03 – 06/30/06

9 Item Disputed Amount

10 Unreported sales \$845,930
 11 Negligence penalty \$13,844

	<u>Tax</u>	<u>Penalty</u>
12 As determined	\$170,838.61	\$17,083.84
13 Adjustment - Sales and Use Tax Department	<u>-32,402.58</u>	<u>-3,240.25</u>
14 Proposed redetermination	\$138,436.03	\$13,843.59
15 Less concurred	<u>-71,531.93</u>	<u>00.00</u>
16 Balance, protested	<u>\$ 66,904.10</u>	<u>\$13,843.59</u>
17 Proposed tax redetermination	\$138,436.03	
18 Interest through 10/31/10	71,515.85	
19 Negligence penalty	<u>13,843.59</u>	
Total tax, interest, and penalty	\$223,795.47	
20 Payments	<u>- 259.70</u>	
Balance Due	<u>\$223,535.77</u>	

20 Monthly interest beginning 11/1/10 \$806.03

21 This matter was previously scheduled for Board hearing on June 17, 2010, but was postponed
 22 because petitioner's representative had a scheduling conflict.

23 **UNRESOLVED ISSUES**

24 **Issue 1:** Whether adjustments are warranted to the audited understatement of reported taxable
 25 sales. We recommend no further adjustments.

26 Petitioner operates a bar and cigar lounge. During its preliminary examination of the records,
 27 the Sales and Use Tax Department (Department) found several discrepancies between amounts
 28 recorded on profit and loss statements and in the sales journals, the amounts reported on federal

1 income tax returns (FITR's), and the amounts reported on sales and use tax returns (SUTR's). The
2 Department decided to establish audited taxable sales on a markup basis. The Department used shelf
3 tests to compute audited markups of about 425 percent for bar sales and 292 percent for sales of
4 tobacco products. To establish the audited cost of bar sales, the Department used purchase information
5 obtained from vendors, which it reduced by audited purchases of mixes and supplies, 4.5 percent for
6 self consumption, and the standard allowances of 1 percent for beer bottle breakage, 2 percent for
7 pilferage, and 10, 6, and 12 percent, respectively, for overpouring and spillage of draft beer, wine, and
8 liquor. To establish the audited cost of tobacco products, the Department reduced audited purchases
9 established using petitioner's check register, by 2 percent for self-consumption and 2 percent for
10 pilferage. Using the markup method, the Department computed audited tax-included bar sales of
11 \$2,528,784 for the audit period and sales of tobacco products of \$204,206 for the period January 1,
12 2004, through June 30, 2006.¹

13 Petitioner disputed the findings of the audit, contending that the markup method was not
14 appropriate because of the changes in the nature of the business over the audit period.² Petitioner
15 suggested that the Department use an analysis of the ratio of credit card sales to total sales. Petitioner
16 provided information from the Point of Sales system it had installed in 2006, from which it had
17 computed a credit card to total sales ratio of 44.85 percent for five weeks. Petitioner first computed net
18 credit card settlement deposits,³ and then divided that figure by 0.4485 to compute total bar and
19 tobacco sales for the audit period of \$1,635,431. Using that figure and a cost of sales figure that had
20 been adjusted for allowances of 2 percent (rather than 1 percent) for beer bottle breakage and 4 percent
21 (rather than 2 percent) for pilferage, petitioner computed markups of 278 percent for 2004, 153 percent
22 for 2005, and 185 percent for the first six months of 2006, or 199 percent overall. Petitioner asserted
23 that a markup of 199 percent was reasonable for this business.

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25 ¹ The amount of tobacco products sold during the last six months of 2003 was not separately computed in the audit.
26 Instead, the percentage of error for 2004 was applied to reported taxable sales for the last six months of 2003.

27 ² Petitioner also argued that the amounts computed using the markup method were overstated because the audited pour
size should be increased from 1.75 ounces to 2 ounces and that the various allowances should be increased.

28 ³ Net credit card settlement deposits represented total credit card deposits net of credit card fees. As explained in the
D&R, we question the rationale of deducting credit card fees before projecting the credit card ratio. However, we have not
researched this issue further because it is not crucial to the remainder of our analysis.

1 The Department found that petitioner's analysis of the credit card ratio was not an effective
2 audit method. First, the Department noted that the five weeks used as a test period to establish the
3 credit card ratio included only one week late in the audit period and four weeks outside the audit
4 period. Referring to petitioner's statement that the clientele had changed significantly during the audit
5 period, the Department found that those five weeks tested were not a reliable indicator of the credit
6 card ratio for the entire audit period. Also, the Department found that the markup of 199 percent was
7 much lower than expected for this business. However, the Department decided to use the information
8 provided by petitioner to compute average weekly bar sales⁴ of \$15,654, which it projected to compute
9 tax included bar sales of \$2,442,012 for the audit period. In the reaudit prepared to make that
10 adjustment, the Department computed tax included tobacco sales of \$236,630⁵ on a markup basis.
11 Thus, the total tax included bar and tobacco sales were \$2,678,642, or \$2,482,117, net of tax. The
12 Department reduced that figure by petitioner's claimed deductions of \$7,838 for the audit period, and
13 added taxable sales of accessories of \$7,096, net of tax, to establish total audited taxable sales of
14 \$2,481,375, net of tax, which exceeded reported taxable sales by \$1,671,926.

15 Although it agrees with the Department's audit method for periods before 2005, petitioner
16 contends that for periods beginning January 1, 2005, its analysis of the credit card sales to total sales
17 ratio should be used to establish taxable sales. Petitioner has computed an understatement of reported
18 taxable sales of \$825,996, so the amount in dispute is \$845,930 (\$1,671,926 – \$825,996). The
19 Department has expressed concern that the 199 percent markup calculated using petitioner's figures
20 appears low. The Department notes it found the average weekly sales of \$15,654 reasonable because
21 the markup calculated using those audited sales and audited cost of good sold was 322 percent, which
22 was closely comparable to the 321.25 percent markup computed in a short shelf test⁶ at the beginning
23 of the audit. At the appeals conference petitioner responded to that concern with an assertion that the
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25 ⁴ Although petitioner intended to establish its total sales using the credit card ratio, including bar sales and sales of tobacco
26 products, the Department noted petitioner's sales of tobacco products waned in the later portion of the audit period. Thus,
27 the Department concluded that the average weekly sales computed using the credit card ratio represented bar sales only.

28 ⁵ This amount represents the tobacco sales for the entire audit period, while the \$204,206 mentioned previously does not
include sales for the last three quarters of 2003.

⁶ The short shelf test was computed for preliminary analysis, before the Department computed the markup of about 425
percent in the full shelf test.

1 Department's markup calculations did not incorporate petitioner's frequent sales of drinks at reduced
2 prices, and petitioner provided documentation of special drink prices after the conference.

3 We find petitioner has supported its assertion that it frequently sold drinks at reduced prices.
4 However, using petitioner's computed sales, adjusted for sales of tobacco products, we have computed
5 a markup for bar sales of 147.2 percent for the period beginning January 1, 2005, which is less than
6 half the markup computed by the Department in the short shelf test. We have also incorporated the
7 promotional selling prices documented by petitioner into the shelf test. Based on our detailed review
8 explained in the D&R, we conclude that the promotional pricing accounts for a reduction in the
9 markup from 425 percent, established in a full shelf test, to 322 percent, as computed using the taxable
10 sales established in the reaudit, and that no further adjustments are warranted for the promotional
11 prices.

12 **Issue 2:** Whether petitioner was negligent. We conclude that it was.

13 The Department imposed the negligence penalty because it found that the poor condition of
14 petitioner's records, the large error rates, and a significant understatement of recorded purchases were
15 all evidence of negligence in compiling and reporting taxable sales. Petitioner disputes the negligence
16 penalty, noting that this was its first audit, and stating that it did not fully understand its reporting
17 responsibilities prior to the audit. Further, petitioner states that it has since improved its recordkeeping
18 and reporting procedures.

19 In analyzing the issue of negligence, we are influenced particularly by the discrepancies in
20 petitioner's records. The amounts of sales recorded on the profit and loss statements exceeded the
21 amounts reported on the FITR's, which exceeded the amounts reported on SUTR's. For the period
22 July 1, 2003, through March 31, 2006, there was an unexplained discrepancy of \$253,451 between the
23 sales amounts recorded on the profit and loss statements and amounts reported on SUTR's, which
24 represented about 19 percent of recorded gross receipts of \$1,310,828. Also, although the evidence
25 indicates that the business was open every day of the year, no sales were recorded in petitioner's sales
26 journals for 70 days during the period October 2003 through April 2006. In addition, based on a
27 comparison with information provided by vendors, the Department found that petitioner's recorded
28 purchases were understated by over \$100,000 for 2005. Further, petitioner's purchase receipts were

1 incomplete. We find these deficiencies to be evidence of negligence in record keeping. Moreover, we
2 note that the total understatement of \$1,676,926 represents a percentage of error of 206.55 percent in
3 comparison to reported taxable sales of \$809,435. Thus, the amount of understatement is significant
4 both as an absolute amount and in relation to reported sales. Further, even if the understatement were
5 limited to the amount computed by petitioner of \$825,996, the percentage of error would still exceed
6 100 percent. For all these reasons, we find that the understatement was the result of negligence, and
7 the penalty was properly applied.

8 **OTHER DEVELOPMENTS**

9 None.

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11 Summary prepared by Rey Obligacion, Retired Annuitant
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MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%
Mark-up percentages developed	Cigars 292.43% Cigarettes 77.08%
Self-consumption allowed in dollars	For the audit period Cigars \$984 Cigarettes \$604
Self-consumption allowed as a percent of total purchases	2%
Pilferage allowed in dollars	For the audit period Cigars \$963 Cigarettes \$592
Pilferage allowed as a percent of total purchases	2%