CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Administrative Protest Under the Sales and Use Tax Law of:	
CLUB RED SQUARE, LLC	Account Number SR AC 100-604456 Case ID 510332
Taxpayer	Woodland Hills, Los Angeles County

Type of Business: Nightclub

Audit period: 10/01/05 – 06/30/08

Item	Disputed Amount
Unreported taxable sales	$780,881
Disallowed claimed "other" deductions	$ 68,000
Negligence penalty	$ 8,227

	Tax	Penalty
As determined	$86,398.46	$ 8,639.85
Finality penalty		8,079.85
Post-D&R adjustment	- 4,125.00	- 825.00
Proposed liability	$82,273.46	$15,894.70
Less concurred	- 12,240.77	00.00
Balance, protested	$70,032.69	$15,894.70

Tax, as adjusted	$ 82,273.46
Interest through 10/31/12	30,749.50
Negligence penalty	8,227.35
Finality penalty	7,667.35
Total tax, interest, and penalty	$128,917.66
Payments	- 6,813.64
Balance Due	$122,104.02
Monthly interest beginning 11/01/12	$ 377.30

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the unreported taxable sales. We find no adjustment is warranted.

Taxpayer operated a nightclub from June 15, 2005, through June 30, 2008. Taxpayer reported no sales for the first quarter 2007 (1Q07), and, for the remaining ten quarters in the audit period, it reported average taxable sales of $13,954 per quarter, or $4,651 per month. Taxpayer provided no books and records for audit. The Sales and Use Tax Department (Department) considered the reported amounts of sales lower than expected for this type of business.

Since taxpayer provided no books and records and the business was closed before the audit was initiated, the Department did not have information to conduct a shelf test, and it could not conduct an observation test. The Department estimated a percentage of understatement of reported sales of 400 percent, and it applied that percentage to taxpayer's reported total sales for 10 quarters of $207,540 ($139,540 reported taxable + $68,000 claimed deductions) to compute an understatement of $830,160. For 1Q07, the Department estimated taxpayer would have reported $19,819, and added an additional understatement of $79,276 (400 percent of the estimated amount that would have been reported). Thus, the Department computed unreported sales of $929,254 ($830,160 + $19,819 + $79,276).

Taxpayer has computed an understatement of $148,373, and disputes the remaining $780,881 of the audited understatement. Although taxpayer had provided no records for audit, it thereafter did provide voluminous documentation, as described in the D&R. The Department reviewed that documentation, concluding that no adjustment was warranted because of various deficiencies and inconsistencies in that documentation.

Although the percentage of understatement in reported sales was an estimate, the Department made some rough cost of living calculations in the Report of Office Discussion, using estimated rent of $15,000 per month, estimated payroll and utilities of $3,000 per month, and a markup of 150 percent, and computed a percentage of understatement of 377 percent. Since that percentage of error is close to the percentage the Department used to compute understated sales and is based on a markup of only 150 percent, which is much lower than the 300 to 500 percent markup expected for a nightclub, we find the Department's use of a 400 percent understatement in its audit computations to be reasonable, if not generous. Further, we have reviewed the records provided during the appeals process, and we find them unreliable for several reasons. For example, while the cash register tapes reflect credit card sales, the bank statements provided do not reflect any credit card deposits, which indicates that taxpayer had at least one other bank account. There are also several inconsistencies between sales reported on the federal tax returns, sales recorded in the general ledger, and amounts deposited in the bank, and the cost of goods sold claimed on the federal tax returns is not consistent with the amounts recorded in the general ledger. Perhaps the most troublesome fact is that the cost of goods sold reported on federal tax returns of $281,819 for 2006, 2007, and 2008 exceeds total sales of $205,455 reported on sales and use tax returns for the same years. In short, we find the documentation provided by taxpayer is incomplete, inconsistent, and unreliable. Thus, it is not sufficient to support any adjustments, and we recommend none.

Issue 2: Whether adjustments are warranted to the disallowed claimed deductions. We find no adjustment is warranted.

The Department disallowed all of the $68,000 in "other" deductions taxpayer claimed on its sales and use tax returns. Taxpayer contends that the $68,000 represents income from rental of the facility only, with no associated sales of food, beverages, or other tangible personal property.

Taxpayer has provided evidence that it had income from the rental of the premises. However, the amount taxpayer compiled from bank deposits totaled $531,966, while the amount of rental income recorded in the general ledger totaled $490,066. Of course, neither of these amounts bear any obvious relationship to the much lesser amount of $68,000 in disallowed claimed deductions, and the records are not sufficiently complete or consistent to identify the source of those claimed deductions. As described above, we conclude that the Department's audit method in computing taxable sales was entirely reasonable, and we conclude that taxpayer has not established any basis for a deduction of $68,000, or other amount, from that amount of taxable sales.

Issue 3: Whether taxpayer was negligent. We conclude that it was.

The Department imposed the negligence penalty because taxpayer had provided no records for the audit and the amount of understatement is substantial. Taxpayer disputes the penalty because any understatement was the result of the lack of business experience of Mr. Mike Nichole (a member of taxpayer LLC who appeared at the conference) and his limited English skills and his health problems.

While a language barrier may have contributed to reporting errors by taxpayer, Mr. Nichole was sufficiently aware of sales and use tax matters to obtain a seller's permit and file sales and use tax returns. Further, although records were not provided for the audit, records were eventually provided during the appeals process that taxpayer apparently had maintained during the audit period, and there were conspicuous inconsistencies in those records which should have been recognized by any business person, even one with limited experience. The most glaring of these inconsistencies for purposes here is that the cost of goods sold reported on federal tax returns exceeded total sales reported on sales and use tax returns. This discrepancy should have made it obvious to taxpayer that reported sales were understated. In addition, taxpayer itself concedes understated taxable sales of $148,373, which is an understatement in excess of 100 percent, and the audited understated taxable sales of $929,254 is an understatement in excess of 650 percent. Although taxpayer had not been audited previously, we find that the deficiencies and inconsistencies in the records that were eventually provided during the appeals process (none having been provided for audit) and the substantial understatement are clear evidence of taxpayer's negligence. We therefore conclude the negligence penalty has been correctly imposed.

RESOLVED ISSUE

The Department included a final sale of fixed assets of $50,000.00 in the audit. After the appeals conference, taxpayer submitted documentation that a sale of the business was never consummated. The Department concludes that the escrow was cancelled, and there was no sale of fixed assets. Accordingly, the unreported sale of fixed assets has been deleted.

OTHER MATTERS

Since taxpayer did not timely pay the determination or file a petition for redetermination, a finality penalty was added. Although we explained to taxpayer that it could request relief of the finality penalty, and provided a form it could use, it has not done so. Accordingly, we have no basis to consider recommending relief of the finality penalty.

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