

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petition for Redetermination)
4 Under the Sales and Use Tax Law of:)5 FRANGI'S RESTAURANT, INC.,)
6 dba The Terrace)Account Number: SR AS 99-747878
Case ID 433581

7 Petitioner)

Venice, Los Angeles County

8 Type of Business: Restaurant with bar

9 Audit period: 01/01/98 – 09/30/06

10 Item Disputed Amount11 Unreported taxable sales \$2,149,880
12 Penalties \$ 334,779TaxPenalty

13 As determined \$1,421,188.90 \$551,210.12

14 Adjustment - Appeals Division - 561,968.03 - 227,359.63

- 92,768.78 - 52,789.51

15 Proposed redetermination \$ 766,452.09 \$271,060.98

Less concurred - 589,415.37 00.00

16 Balance, protested \$ 177,036.72 \$271,060.98

17 Proposed tax redetermination \$ 766,452.09

Interest through 02/29/12 579,942.95

18 Fraud penalty 191,613.21

19 Amnesty double fraud penalty 79,447.77

Amnesty interest penalty 63,718.23

20 Total tax, interest, and penalty \$1,681,174.25

Payments 60,000.0021 Balance Due \$1,621,174.2522 Monthly interest beginning 03/01/12 \$ 4,120.9723 This matter was scheduled for Board hearing in October 2011, but was postponed at
24 petitioner's request to allow additional time to prepare for hearing.25 **UNRESOLVED ISSUES**26 **Issue 1:** Whether further reductions are warranted to the amount of unreported taxable sales.

27 We find no further adjustments are warranted.

1 Petitioner operates a restaurant with a bar. The only records petitioner provided for audit were
2 summary pages of bank statements for 2004 and 2005, and sales and use tax returns and federal
3 income tax returns for the years 2003, 2004, and 2005.

4 The Sales and Use Tax Department (Department) found that the cost of goods sold reported on
5 federal returns for 2003, 2004, and 2005 substantially exceeded the amounts of total sales reported on
6 petitioner's sales and use tax returns for those years, and the gross receipts of \$4,089,037 reported on
7 the federal returns exceeded total sales of \$574,051 reported on sales and use tax returns by
8 \$3,514,986, an understatement of more than 600 percent. Petitioner's California income tax returns for
9 the years 1998 through 2002 reflected gross receipts of \$4,504,502, which exceeded total sales of
10 \$848,673 reported for sales tax purposes by \$3,655,829, an understatement of more than 400 percent.
11 The total difference between sales reported for income tax purposes and sales reported for sales tax
12 purposes is \$7,170,815, which petitioner concedes represents unreported taxable sales.

13 The Department then reviewed the bank statements for 2004 and 2005 and found that the
14 amounts deposited significantly exceeded the amounts of gross receipts reported on petitioner's federal
15 returns. The Department decided to use bank deposits to establish audited sales, which resulted in an
16 understatement of \$17,290,156. Based on adjustments conceded by the Department and as
17 recommended in the D&R, the understatement of reported taxable sales was reduced to \$10,453,263.

18 In preparation for the previously-scheduled Board hearing, the Department recommended
19 additional adjustments. Specifically, the measure of tax recommended by the D&R was based on the
20 Department's computations, applying the average error rate for the years 2002 through 2005 to the
21 other portions of the audit period, excluding the third quarter 2006, which was accepted as reported.
22 The Department noted that there was an increasing understatement of tax in each year from 2002
23 through 2005 and concluded that it would be more appropriate (and favorable to petitioner) to apply
24 the percentage of error for 2002 to the years prior to 2002 and to apply the percentage of error for 2005
25 to the two quarters of 2006 for which understatements were computed. However, applying the
26 percentage of error to 2001 would reduce the measure below the gross receipts petitioner reported on
27 its 2001 state income tax return. Since there is no evidence petitioner over reported its sales on its
28 2001 income tax return and all gross receipts were taxable, the Department finds that the gross receipts

1 reported for income tax purposes should be accepted as audited taxable sales for 2001. Accordingly,
2 applying the 2002 error to 1998 through 2000, using gross receipts reported for income tax purposes in
3 2001 as audited taxable sales, and applying the 2005 error to the first two quarters of 2006, the
4 Department now recommends that the amount of unreported taxable sales be reduced by \$1,132,568,
5 from \$10,453,263 to \$9,320,695.

6 Petitioner disputes \$2,149,880, which is the amount in excess of the \$7,170,815 understatement
7 it concedes. Petitioner asserts that the bank deposits include amounts not attributable to taxable sales
8 and that the adjustment for tips should be based on tips of 19 percent rather than the 16.58 percent used
9 in the computation of the deficiency. In the virtual absence of records, we find it was appropriate for
10 the Department to establish audited sales based on bank deposits. Petitioner has not shown that any
11 further adjustments are warranted for non-sale deposits or for tips in excess of 16.58 percent.
12 Accordingly, we recommend no further adjustments.

13 **Issue 2:** Whether the Department has established fraud by clear and convincing evidence.¹ We
14 find that it has.

15 The Department imposed the fraud penalty because it found that petitioner had knowledge of
16 the proper application of tax and because of the substantial understatement, the virtual absence of
17 records, and the substantial discrepancies found in the available records that could not be explained
18 satisfactorily as being the result of negligence. Petitioner contends that the sales and use tax returns
19 were prepared by an in-house bookkeeper and that it had no knowledge of the substantial
20 understatements in reported taxable sales.

21 We find that petitioner was knowledgeable regarding the application of the sales tax to its sales
22 because it regularly filed sales and use tax returns and it charged sales tax reimbursement on its sales
23 of tangible personal property. Further, petitioner has conceded that the difference of \$7,170,815
24 between amounts reported for income tax purposes and those reported for sales tax purposes for the

25
26 ¹ Without regard to whether the finding of fraud is upheld, since petitioner did not participate in the amnesty program, the
27 determination is timely for the period July 1, 2001, through December 31, 2002, under the 10-year amnesty statute of
28 limitations. (Rev. and Tax. Code § 7073, subd. (d).) The determination is also timely for the period October 1, 2004,
through September 30, 2006, under the general 3-year statute of limitations. (Rev. & Tax. Code, § 6487, subd. (a).) The
determination is timely for the periods January 1, 1998, through June 30, 2001, and January 1, 2003, through September 30,
2004, only if the finding of fraud is upheld.

1 years 1998 through 2005 represented taxable sales. In other words, petitioner concedes that it knew it
2 had made sales in excess of \$7 million that it had not reported on its sales and use tax returns. That
3 difference alone represents an understatement of more than 500 percent in comparison to the amount
4 reported for those eight years of \$1,422,724, and the understatements occurred consistently throughout
5 the years 1998 through 2005.

6 Petitioner claimed at the conference that any proceeds from unreported sales were used to
7 remodel the business and not for personal gain, effectively conceding that it diverted amounts received
8 from its purchasers as sales tax reimbursement to various business expenses, rather than paying tax to
9 the Board. This failure to pay tax, and the use of those funds for other business expenses, is strong
10 evidence of an intent to evade the tax. Also, we find that petitioner's statement is inconsistent with its
11 assertion that it was unaware of the understatements since the returns were prepared by an in-house
12 bookkeeper. In addition, petitioner has provided no credible non-fraudulent reason why the total sales
13 reported on its sales and use tax returns were less than the cost of goods sold reported on its federal
14 income tax returns. We also note that the audited understatement of \$9,320,695 for the entire audit
15 period represents an understatement of about 440 percent in comparison to reported taxable sales of
16 \$2,105,502. We find that the Department has provided clear and convincing evidence that the
17 understatement was the result of fraud, and that the penalty was properly applied.

18 **Issue 3:** Whether relief of the amnesty penalties is warranted. We find relief is not warranted.

19 Since petitioner did not participate in the amnesty program, an amnesty double fraud penalty
20 was added to the determination, and an amnesty interest penalty will be added when the liability
21 becomes final. Petitioner requests relief on the grounds that it was never in violation of Revenue and
22 Taxation Code section 7073 and 7074. Since this general, unsupported statement does not provide a
23 reasonable explanation for having failed to participate in the amnesty program, we conclude that relief
24 should be denied.

25 OTHER DEVELOPMENTS

26 None.

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