CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: JUAN MANUEL GALLARDO, dba Gallardo's Mexican Restaurant Petitioner	Account Number: SR BH 99-786856 Case ID 466120 San Francisco, San Francisco County

Type of Business: Restaurant

Audit period: 07/01/04 – 06/30/07

Item	Disputed Amount
Unreported sales	$504,028
Negligence penalty	$ 5,913

	Tax	Penalty
As determined:	$66,084.11	$6,608.42
Adjustment - Appeals Division	- 6,958.62	- 695.83
Proposed redetermination	$59,125.49	$5,912.59
Less concurred	- 16,283.05	00.00
Balance, protested	$42,842.44	$5,912.59

Proposed tax redetermination	$59,125.49
Interest through 1/31/11	24,816.82
Negligence penalty	5,912.59
Total tax, interest, and penalty	$89,854.90
Payments	- 0.38
Balance Due	$89,854.52
Monthly interest beginning 2/1/11	$ 344.90

A Notice of Appeals Conference was mailed to petitioner's address of record, with a copy to his representative, and neither notice was returned by the Post Office. Neither petitioner nor his representative responded to the notice or appeared at the appeals conference, which was held as scheduled. We thereafter sent petitioner a letter offering him the opportunity to provide any additional arguments and evidence in writing he wished us to consider. Petitioner responded in a letter, restating the arguments he had made previously.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the audited amount of unreported sales. We recommend no further adjustment.

Petitioner has operated a restaurant since October 1995. At the time of the audit, the restaurant was open seven days a week. Petitioner provided limited records for audit. The Sales and Use Tax Department (Department) found that the amounts of total sales reported on sales and use tax returns reconciled with the amounts reported on the two federal income tax returns petitioner provided, for 2004 and 2005. The Department calculated book markups based on the total sales petitioner reported on sales and use tax returns and the costs petitioner reported on income tax returns. Although the Department considered these markups to be reasonable for this business, the Department did not use the markups to establish audited taxable sales because the cost and sale amounts used in the calculation could not be verified (petitioner did not maintain purchase invoices or any guest checks for the audit period).

The Department found that the funds deposited in the bank were significantly greater than petitioner's reported total sales, and it regarded that difference as evidence that reported total sales were understated. The Department decided to establish audited sales using total credit card deposits recorded on the bank statements and an audited percentage of credit card sales to total sales. The Department noted that the amounts of credit card deposits were net of certain fees paid to credit card merchants. Based on a test of merchant card statements, the Department computed that the amount deposited in the bank represented 96.3665 percent of the amounts that petitioner's customers had charged on credit cards. The Department used that percentage to compute total sales paid by credit card for the audit period. It then observed petitioner's business for three partial days and computed that, for the periods of observation, the percentages of credit card sales to total sales were 40.66 percent, 24.32 percent, and 28.13 percent. In the D&R, we found inconsistencies in the computation of the 24.32 percent, and we recommended that the results of the observation for that day be removed from the computations. After that adjustment, the audited ratio of credit card sales to total sales is 32.63 percent. Then, following the same procedure the Department had used in the audit, we divided total credit card charges by 0.3263, reduced the total by 8 percent for tips, and then removed the sales tax included. We computed audited taxable sales of $855,028, which represents an understatement of $695,593 in comparison to reported taxable sales of $159,435.

Petitioner contends that his sales were in the range of $400 to $500 per day, and states that he was open only five days a week during the audit period. He states the restaurant hours changed to seven days a week just before the audit began. Petitioner asserts that the Department's observation tests support his estimate of daily sales of $400 to $500. Further, he states that the credit card sales ratio method used to develop audited taxable sales produced an incorrect result because the credit card ratio fluctuates daily.

Petitioner did not provide guest checks or a sales journal for audit. Further, the amount of credit card deposits of $317,045 (which by definition includes no cash sales) are almost double the amount of reported taxable sales of $159,435. Also, for the years 2005 and 2006, petitioner's purchases from its primary food vendor were $210,117, more than twice the $97,882 that petitioner had reported as taxable sales for those years. In light of these discrepancies together with the limited records, we find the Department's decision to use an alternate audit method was entirely appropriate. Further, as a general comment, we find the credit card method is an effective audit procedure, particularly under the circumstances of this case.

With respect to petitioner's assertion that his sales were in the range of $400 to $500 per day and that he was only open five days a week, we have used those figures to calculate taxable sales of $351,000 for the audit period, which is significantly less than the $511,288 deposited in the bank for the audit period. We simply do not accept petitioner's estimate of his sales since it is far less than the funds he deposited in the bank. Further, petitioner made a total of $310,926 of purchases from his primary food vendor during the audit period. If these had been all of his merchandise purchases, his estimated sales of $351,000 results in a markup of only 13 percent, far below the expected markup of at least 200 percent for this business. (Since he likely made some merchandise purchases from other vendors, his actual cost of goods sold during the audit period was probably greater than $310,926. If so, the resulting markup based on his estimated sales would actually be less than 13 percent.)

We also reject petitioner's assertion that the Department's observation tests support his estimate of daily sales of $400 to $500 since the Department did not observe the business for an entire day. Projecting the sales made during the hours of operation that the Department actually observed results in average daily sales for the test days of $828. Nor do we accept petitioner's statement that the restaurant was open only five days a week during the audit period since petitioner has provided no evidence that the restaurant schedule was different during the audit period. In fact, the Department found a restaurant review dated July 29, 2005 (near the beginning of the second year of the audit period), which stated the business was open on Sundays. For all these reasons, we reject petitioner's contention that the audited taxable sales should be based on an estimate of daily sales of $400 to $500, for five days of each week of the audit period. We conclude that no further adjustments are warranted.

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

The Department imposed the negligence penalty because the books and records were inadequate for sales and use tax purposes, and the understatement was significant in relation to the reported measure of tax. Petitioner has not specifically disputed the negligence penalty.

The records provided for audit were severely limited. Petitioner did not provide a sales journal, purchase journal, or source documents. We find that the absence of records is evidence of a lack of due care in record keeping. We also note that the credit card deposits of $317,045 are almost double the amount of reported taxable sales of $159,435. In addition, petitioner's merchandise purchases from its primary food vendor were $310,926, which also substantially exceeded reported taxable sales. These broad discrepancies should have alerted petitioner to the fact that his reported taxable sales were far less than his actual sales. Petitioner's understatement is $695,593, which is an understatement of 436 percent in comparison to reported taxable sales of $159,435, and which is substantial both as an absolute amount and in relation to reported amounts. We find that that this is a clear case of negligence and that the penalty was therefore properly applied.

OTHER DEVELOPMENTS

None.

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