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:	)	
HUKILAU, LLC	)	Account Number SR BH 100-035105 Case ID 533841
Petitioner	)	City and County of San Francisco

Type of Business: Restaurant with a full bar

Audit period: 10/01/05 – 09/30/08

Item	Disputed Amount
Unreported taxable sales	$583,149

	Tax	Penalty
As determined	$55,605.29	$5,560.58
Post-D&R adjustment	00.00	- 5,560.58
Proposed redetermination	$55,605.29	$ 00.00
Less concurred	- 6,037.56	
Balance, protested	$49,567.73	
Proposed tax redetermination	$55,605.29	
Interest through 11/30/12	25,480.86	
Total tax and interest	$81,086.15	
Monthly interest beginning 12/01/12	$ 278.03	

This matter was scheduled for Board hearing on September 13, 2012, but was rescheduled to November because the meeting for September 13 was canceled.

UNRESOLVED ISSUE

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

Petitioner has operated a restaurant with a full bar since April 2002. Petitioner's reported sales were based on summaries prepared from cash register z-tapes for a portion of the audit period and based on its point-of-sale (POS) system for the remainder of the audit period. For audit, petitioner provided: federal income tax returns; profit and loss statements (P&L's) for 2007 and the first three quarters of 2008; some bank statements, merchant statements, and purchase invoices; and its current credit card settlement summaries and POS reports. The Sales and Use Tax Department (Department) found various discrepancies in the records and decided to establish audited sales on a markup basis.

The Department computed a liquor markup of 383.11 percent based on the available information (providing the standard allowances set forth in the audit manual, and, as stated by petitioner, using a liquor pour size of 1.5 ounces and regarding 35 percent of eligible drinks as having been sold at discount during happy hour), and used a markup of 200 percent for the restaurant based on its experience in auditing restaurants of this type. Applying these markups to audited purchases and deducting reported taxable sales resulted in an audited understatement of $1,035,374. Petitioner contended that it could not have generated the audited sales given the seating capacity of the restaurant. The Department thus decided to perform a credit card ratio analysis to verify whether audited taxable sales were reasonable. This analysis, based on POS reports provided by petitioner for nine days in mid-2009 (after the audit period), resulted in a ratio of 62.44 percent of sales paid by credit card and 37.56 percent paid by cash. The Department divided credit card deposits for the audit period by 0.6244 (with appropriate adjustments for tax reimbursement and gratuities included in the deposits) and deducted reported sales to compute that use of this method would result in an understatement $318,976. The Department also computed that the total sales based on the credit card ratio would equate to a markup of 183.06 percent.

The Department concluded that this markup was unrealistic since this total markup is less than would be expected for the restaurant side alone, and does not account for the far higher markup for liquor. The Department therefore concluded that the credit card sales ratio analysis was not a reliable audit method in this case. Nevertheless, since this analysis failed to verify the Department's original audit computations and petitioner's contentions regarding the size of the restaurant appeared reasonable, the Department decided to make significant adjustments to its original markup computations.

The revised audit increased the overall pour size for liquor from the 1.5 ounces stated in the Bar Fact Sheet to 1.75 ounces and corrected an error in the computation of the beer markup, resulting in a reduction in the markup for alcoholic beverages from 383.11 to 341.71 percent. The revised audit retained the 200 percent markup for food. The revised audit made significant adjustments to cost of goods sold. For alcoholic beverages, self-consumption was increased from $2,019 per quarter to $2,700 per quarter (approximately 13 percent of purchases), pilferage was increased from 2 percent to 3 percent, and a separate adjustment was made for bar supplies included in recorded alcoholic beverage purchases, computed at 3 percent, even though petitioner had a separate account in which it recorded mixers and supplies. For food purchases, self-consumption was increased from $3,042 per quarter to $4,200 per quarter (approximately 8 percent of purchases), the spoilage allowance was increased from 2 percent to 5 percent, and pilferage of 2 percent was allowed. The revised audit then applied the markups to cost of goods sold to compute total audited sales, deducted petitioner's claimed nontaxable sales for resale and its reported taxable sales to compute the revised audited understatement of $621,779.[1]

Petitioner contends that, due to mismanagement and poor controls over its inventory, its inventory purchases do not correspond closely with its sales as with most other similar businesses, especially during 2007 when "Monica" was general manager. On that basis, petitioner contends that the markup audit approach is not reliable in this case. Petitioner particularly objects to the use of the percentage of error for 2007 in the computation of the percentage of error for periods before 2007 because of Monica's particularly egregious mismanagement. In order to avoid having to project the 2007 error to the earlier portions of the audit period, petitioner asserts that the results of the credit card sales ratio analysis should be used to establish the audited understatement.

The markup applicable if total sales were computed using the credit card analysis would be 183.06 percent. This percentage is below the 200 percent the Department used for food alone, and a 200 percent markup is at the minimum end of the range of markups we would expect for food at this type of restaurant. We do not know why the credit card analysis produces such an aberrant result, but we nevertheless conclude that the results of the credit card analysis are not a reliable representation of petitioner's business.

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[1] Both the original audit and the revised audit examined the period January 1, 2007, through September 30, 2008, computed the percentage of error for that period, and then applied that percentage of error to the earlier part of the audit period to compute the audited deficiencies noted in text.

Regarding petitioner's claims about inventory controls and about the circumstances when Monica was general manager, we find no evidence in the records that petitioner's inventory purchases do not correspond closely with its sales. In fact, we find that, where the recorded cost of goods sold increased, the credit card sales increased at about the same rate, which does not indicate that there were huge losses of inventory that had to be replaced with additional purchases. Furthermore, the revised audit includes adjustments that are particularly favorable to petitioner, some of which were allowed primarily because of petitioner's unsupported assertion that Monica gave away substantial amounts of petitioner's inventory during 2007.[2] Accordingly, we find there is no evidence to support further reductions in the audited cost of goods sold or any other adjustments in the markup computations.

RESOLVED ISSUE

The Department imposed a negligence penalty because petitioner's records were inadequate, and the understatement of reported taxable measure of $654,179 (unreported taxable sales of $621,779 plus the unreported cost of self-consumed taxable merchandise of $32,400) was substantial and represented an error ratio of 38 percent. While we agree that an average reporting error rate of 38 percent is significant, we note that the error rate decreased from 64.05 percent for 2007 to 9.99 percent for 2008, which shows that petitioner significantly improved the accuracy of its reporting in the last three quarters of the audit period. Since this is petitioner's first audit, we find that those improvements are evidence that the understatement was not the result of negligence and that the penalty should be deleted.

OTHER MATTERS

None.

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

[2] Our experience is that thefts of cash are far more likely than thefts of merchandise. Thefts of cash would not reduce audited taxable sales in a markup examination, and thus would not affect the audited deficiency here.

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%
Mark-up percentage – alcohol (shelf test) - food (estimated)	341.71% 200%
Self-consumption allowed in dollars (1/1/07 – 9/30/08) Alcohol Food	 $18,900 $ 29,400
Self-consumption allowed as a percent of taxable purchases	13% - Alcohol 8% - Food
Pilferage allowed in dollars – (1/1/07 – 9/30/08) Alcohol Food	 $3,718 $6,998
Pilferage allowed as a percent of taxable purchases Alcohol Food	 3% 2%
Spoilage of food allowed in dollars	$17,495
Spoilage of food allowed as a percent of purchases	5%