

## 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 J &amp; L PHANG, INC., dba Bayside )

6 Petitioner )

Account Number: SR AP 97-939961

Case ID 443371

San Gabriel, Los Angeles County

7 Type of Business: Neighborhood bar

8 Audit period: 07/01/03 – 06/30/06

9 Item Disputed Amount

10 Unreported taxable sales \$1,115,216

11 Negligence penalty \$ 9,248

12 TaxPenalty

13 As determined:

\$99,375.61

\$9,937.53

14 Adjustment - Appeals Division

- 6,899.63- 689.89

15 Proposed redetermination

\$92,475.98

\$9,247.64

16 Less concurred

- 470.5800.00

17 Balance, protested

\$92,005.40\$9,247.64

18 Proposed tax redetermination

\$ 92,475.98

19 Interest through 6/30/10

43,952.99

20 10% penalty for negligence

9,247.64

21 Total tax, interest, and penalty

\$145,676.61

22 Payments

0.20

23 Balance Due

\$145,676.41

24 Monthly interest beginning 7/1/10

\$ 539.4425 **UNRESOLVED ISSUES**26 **Issue 1:** Whether adjustments are warranted to the audited understatement of reported taxable  
27 sales. We recommend no further adjustment.28 Petitioner operates a neighborhood bar selling mostly beer, with some sales of liquor and wine.  
The audit workpapers state that the bar is open from 6:00 p.m. to 1:30 a.m., and it offers drinks at  
reduced prices during a happy hour from 6:00 p.m. to 8:00 p.m. daily.Petitioner provided limited records. The Sales and Use Tax Department (Department) found  
that gross receipts reported on petitioner's federal income tax returns (FITR's) substantially reconciled

1 with the amounts of total sales reported on sales and use tax returns (SUTR's). However, the  
2 Department expected higher markups for this type of business than the 208 and 209 percent it  
3 computed based on petitioner's FITR's. The Department also found that the amount of cancelled  
4 checks petitioner had issued to its vendors of merchandise exceeded the amounts it reported on its  
5 FITR's for cost of goods sold. The Department therefore concluded that the amounts recorded on the  
6 FITR's were not reliable and requested information from petitioners' vendors regarding their sales of  
7 merchandise to petitioner. Since some of the vendors were unable to provide complete purchase  
8 information and the Department found that petitioner's cancelled checks for the period January 1,  
9 2004, through August 31, 2005, were substantially complete, it used that period as a test period to  
10 establish audited purchases.

11 The Department reduced audited purchases for one-half the cost of six-packs of beer sold under  
12 a "two for one" selling price, and then allowed self consumption and pilferage of two percent each of  
13 the net purchases. To establish the audited markups, the Department conducted shelf tests, using costs  
14 from purchase invoices provided by vendors and selling prices provided by petitioner on the Bar Fact  
15 Sheet. The Department computed markups for sales at reduced prices during happy hour and at  
16 regular prices. The Department estimated that 27 percent of petitioner's merchandise was sold during  
17 happy hour ( $2 \text{ hours} \div 7.5 \text{ hours} = 26.66\%$ ), and it computed an overall weighted average markup of  
18 449 percent. The Department marked up the audited cost of goods sold by 449 percent to establish  
19 audited taxable sales, which it compared to reported amounts to compute percentages of  
20 understatement of 387 percent for 2004 and 196 percent for the period January 1, 2005, through  
21 August 31, 2005.

22 In the D&R, we recommended that the Department prepare a reaudit to make an allowance of  
23 one percent for breakage of bottled beer and to reduce audited cost of goods sold to account for  
24 purchases of supply items. The reaudit performed to apply these recommendations reduced the  
25 understatement of reported taxable sales from \$1,198,588 to \$1,115,216. Petitioner contends that this  
26 understatement remains excessive because both the audited markup and audited cost of goods sold are  
27 too high.

28

1           Regarding the markup, petitioner asserts that the percentage of sales at reduced selling prices  
2 during happy hour should be increased. Petitioner states that drinks are sold at reduced selling prices  
3 from 6:00 p.m. to 8:00 p.m., then the bar is closed from 8:00 p.m. to 10:00 p.m. and is open again from  
4 10:00 p.m. to 1:30 a.m. Thus, petitioner argues that drinks are sold at reduced selling prices 36 percent  
5 of the time (2 hours ÷ 5.5 hours). However, petitioner has not provided evidence that it routinely  
6 closed the business from 8:00 to 10:00 p.m. each night, and that description of the bar operations  
7 conflicts with the regular hours stated on the Bar Fact Sheet of 6:00 p.m. to 1:30 a.m. Further, we find  
8 it highly implausible that petitioner's staff turns out whatever customers might be in the bar at 8:00,  
9 shuts down the cash register, leaves for two hours, and then returns to open the bar again. We further  
10 find the Department has used a reasonable method for estimating the percentage of drinks sold during  
11 happy hour. In that regard, the Department has assumed that the sales remained relatively constant  
12 throughout the day, and petitioner has provided no evidence that its volume of sales was higher during  
13 happy hour. Accordingly, we find no adjustment is warranted to the percentage of merchandise sold at  
14 reduced selling prices. In addition, petitioner raises the general contention that the audited markup is  
15 too high. As part of this argument during the conference, petitioner stated that it sells higher quality  
16 Johnny Walker brands for a price higher than the \$80 per bottle the Department used in the shelf test.  
17 At the conference, we attempted, unsuccessfully, to explain to petitioner that adjustment for that error  
18 would increase, rather than decrease, the markup. Based on our review of the shelf tests, we did not  
19 find that any reduction of the markup was warranted. Instead, the only errors we identified in the shelf  
20 test benefited petitioner (by resulting in a lower markup). For these reasons, we find no adjustment is  
21 warranted to the audited markup.

22           Regarding the cost of goods sold, petitioner asserts that it should be adjusted for supply items.  
23 However, as noted above, we already recommended such an adjustment, and petitioner has not  
24 provided evidence to support an increase in the adjustment made in the post-D&R reaudit. In addition,  
25 petitioner contends an adjustment is warranted for ending inventory, but has not provided reliable  
26 evidence of the inventory at the beginning or end of the audit period, or for any other point in the audit  
27 period. In the absence of a detailed, documented inventory, we find no adjustment is warranted.

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

1 The Department imposed the negligence penalty because petitioner's records were inadequate  
2 and incomplete, and the amount of understatement and percentage of error were both substantial.  
3 Petitioner disputes the penalty on the basis that it reported its sales correctly.

4 We have already concluded, under Issue 1, that there was a substantial understatement. Thus,  
5 we reject petitioner's assertion that it reported its sales correctly. We note that the amount of  
6 unreported taxable sales, after the adjustments recommended in the D&R, is \$1,115,216, which  
7 represents a percentage of error of 239 percent ( $\$1,115,216 \div \$466,563$ ). Accordingly, the  
8 understatement is significant, both in the absolute value (in excess of \$1 million) and relative to  
9 reported amounts. Further, petitioner's records were extremely limited, and the available records were  
10 conflicting. The absence of records and the substantial level of error are evidence that petitioner did  
11 not exercise the level of care of a reasonably prudent business person. We find petitioner was  
12 negligent, and the penalty was properly applied.

13 **OTHER DEVELOPMENTS**

14 None.

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17 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III  
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**MARKUP TABLE**

Percentage of taxable vs. nontaxable purchases	100%
Mark-up percentage developed	449%
Self-consumption allowed in dollars	\$3,336 for 1/1/04-8/31/05
Self-consumption allowed as a percent of total purchases	2%
Pilferage allowed in dollars	\$3,269 for 1/1/04-8/31/05
Pilferage allowed as a percent of total purchases	2%