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:	
MARIA ESTHER POLACK, dba Surf City Pizza	Account Number SR EA 100-972642 Case ID 556429
Petitioner	Huntington Beach, Orange County

Type of Business: Restaurant

Audit period: 10/19/07 – 02/28/10

Item	Disputed Amount
Unreported taxable sales	$211,077
Negligence penalty	$ 1,727

	Tax	Penalty
As determined	$21,854.99	$2,185.50
Post-D&R adjustment	- 4,580.98	- 458.11
Proposed redetermination, protested	$17,274.01	$1,727.39

Proposed tax redetermination	$17,274.01
Interest through 07/31/13	5,060.43
Negligence penalty	1,727.39
Total tax, interest, and penalty	$24,061.83
Payments	- 30.14
Balance Due	$24,031.69
Monthly interest beginning 08/01/13	$ 86.22

UNRESOLVED ISSUES

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

Petitioner operated a restaurant from October 19, 2007, through February 28, 2010. According to petitioner, she recorded cash register tape totals and provided the monthly sales amounts to an outside bookkeeper who prepared the sales and use tax returns. For audit, petitioner provided federal income tax returns, bank statements, and a monthly journal of sales.

The Sales and Use Tax Department (Department) found substantial differences between the amounts reported on federal tax returns and those reported for sales and use tax purposes. Also, the

Department noted that the book markups computed using the total sales reported on sales and use tax returns and cost of goods sold reported on the federal returns were 96.07 percent for 2008 and 11.12 percent for 2009, which were much lower than the Department expected for this business. In any event, the Department found the book markups unreliable because petitioner stated that the cost of goods sold amounts on the federal returns were estimated. The Department computed that total sales reported on petitioner's sales and use tax returns represented average daily sales of $60, which the Department found unreasonably low for a restaurant open 10 hours a day.

The Department decided to establish audited taxable sales based on the sales by petitioner's successor in the month immediately following the sale of the business because it found that the successor's operations were similar to petitioner's.[1] Using the successor's sales for March 2010, the Department computed average daily taxable sales of $368, which it used to compute audited taxable sales of $323,417, which exceeded reported amounts by $267,323. In the D&R we recommended an adjustment for Mondays, when petitioner did not open the restaurant, and for certain holidays when the business was closed, which reduced the understatement to $211,077.

Petitioner contends that the audited taxable sales are excessive because the successor's sales are not representative of hers. She asserts that the successor's sales are higher because the successor uses a lot of advertising and because the successor's corporate president lives in the area and has local contacts. Petitioner also stated she sometimes did not charge for orders of additional sauce. In addition, petitioner states that the business was losing money, she went into debt, and she obtained loans from friends to keep the business running and to cover personal expenses. Further, petitioner states she had a helper who sometimes opened the restaurant late and who stole money and beer from the business. Prior to and subsequent to the appeals conference, petitioner provided various types of documentation, including the escrow closing statement for the sale of the business, hand-written weekly sales summaries, and copies of statements from individuals saying that they had made loans to

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[1] The Department considered establishing audited sales on a markup basis but concluded that audit method was unreliable because the cost of goods sold reported on federal returns was estimated and petitioner did not have other reliable information regarding her merchandise purchases. In addition, the Department would have been unable to prepare a shelf test to establish audited markups because the business was closed before the audit began.

petitioner. The Department contacted one of those individuals who stated she had loaned $130,000 to petitioner. She said she gave the money to petitioner as an investor, but she did not describe what she received in return for the large investment.

We find that, as a result of the discrepancies in petitioner's records, and the absence of complete source documentation, such as cash register tapes, it was appropriate for the Department to establish taxable sales using an alternate audit method. Even petitioner has observed that her average daily sales, as reported on her federal tax returns, were $293 in 2008 and $244 in 2009, although the amounts reported on sales and use tax returns reflected average daily sales of only $60. This is strong evidence that reported total sales were grossly understated. Regarding petitioner's assertion that the successor's sales were higher as the result of advertising and the corporate president's contacts in the local community, we note that those differences, even if true, would not have an immediate impact on the business's sales in the first month of the successor's operation. Also, petitioner sated that the successor remodeled the restaurant and changed the concept of the business, but she has provided no evidence of significant changes during the first month of the successor's operation. Further, we have examined a copy of petitioner's menu and the successor's menu and note that the menu items and prices are almost identical. Moreover, we find that the hand-written sales summaries petitioner provided for the appeals conference, which are not supported by source documents such as cash register tapes or guest checks, are not reliable evidence of petitioner's actual sales. In addition, we find petitioner has not provided persuasive evidence that she ran the business primarily on borrowed funds, and, in any event, since the audited understatement is not based on bank deposits, a large amount of business loans would not impact the audit findings. Petitioner has provided no evidence of employee theft of money and beer, but, again, such evidence, if provided, would not impact our conclusion because theft of money after the fact does not alter the amount of petitioner's sales and theft of beer would not be relevant because the audit was not conducted on a markup basis. In summary, we find that none of the evidence provided by petitioner is sufficient to support any further adjustments in the amount of unreported taxable sales.

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

The Department imposed the negligence penalty because petitioner failed to provide adequate books and records. Petitioner disputes the penalty on the basis that it is not fair and that she is unable to pay.

Petitioner did not provide any source documents such as cash register tapes or guest checks, and there were significant discrepancies in the available records. Accordingly we find petitioner did not exercise due care in record keeping. In addition, the understatement of $211,077 represents an error ratio of 376 percent in comparison to reported taxable sales of $56,091. Thus, petitioner reported less than one-fourth of her taxable sales. Moreover, petitioner reported gross receipts on her federal tax returns of $87,877 for 2008 and $73,282 for 2009 but only reported total sales on sales and use tax returns of $30,594 and $16,307, respectively. We find that any business person, even one with limited experience should have noted those broad discrepancies. Thus, we conclude that the inadequate records and the significant understatement in relation to reported amounts are evidence of negligence and that the penalty was properly applied, even though petitioner had not been audited previously.

We find that any financial difficulties petitioner was experiencing would not impact our conclusion regarding the negligence penalty. However, we have informed petitioner of the options of filing a settlement proposal or making an offer in compromise.

OTHER MATTERS

None.

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