

**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: )  
ANDREA J. RUSSO, dba AJ's ) Account Number: SR Y GH 26-798140  
Petitioner ) Case ID 402580  
San Jose, Santa Clara County

Type of Business: Bars with food sales and entertainment

Audit period: 04/01/03 – 03/31/06

<u>Item</u>	<u>Disputed Amount</u>
Unreported bar sales	\$276,451
Tax determined:	\$31,334.36
Adjustment - Sales and Use Tax Department	- 3,184.02
- Appeals Division	<u>- 2,735.31</u>
Proposed redetermination	\$25,415.03
Less concurred	<u>- 2,311.65</u>
Balance, protested	<u>\$23,103.38</u>
Proposed tax redetermination	\$25,415.03
Interest through 5/31/11	<u>13,501.37</u>
Total tax and interest	<u>\$38,916.40</u>
Monthly interest beginning 6/1/11	<u>\$148.25</u>

**UNRESOLVED ISSUES**

**Issue:** Whether additional adjustments are warranted to the audited bar sales established by markup. We recommend no further adjustments.

Petitioner operates two bars, one in San Jose and one in Hayward, both of which provide entertainment (“bikini” dancers). The San Jose location, started in December 1988, is open Monday through Friday from 11:00 am to 1:00 am, Saturdays from 5:00 pm to 2:00 am, and the dancers start performing at about 6:00 pm, at which time drinks are sold at higher “entertainment” prices. The Hayward location, started in July 1994, is open Tuesday through Thursday from 7:30 pm to 1:00 am, Friday and Saturday from 7:30 pm to 2:00 am, and the dancers perform the entire time the business is open, with higher “entertainment” prices charged for drinks. Both locations occasionally collected a

1 cover charge which only entitled patrons admission to the premises. Food was sold at the San Jose  
2 location during the audit period by an unpermitted concessionaire but was not reported. However, the  
3 amount of food sales included in the audit determination is not in dispute. Petitioner had been audited  
4 at least twice previously.

5 The Sales and Use Tax Department (Department) found no differences between the gross  
6 receipts reported on petitioner's sales and use tax returns and on petitioner's federal income tax returns  
7 (FITR's) for 2003 through 2005, but concluded the book markups based on the FITR, ranging from  
8 209 percent to 264 percent, were lower than expected for this type of business. The Department  
9 confirmed this conclusion with a bar short test, in which it computed a weighted markup of 425  
10 percent. Based on the differential, the Department concluded that petitioner's reported taxable sales  
11 were understated, and decided to establish petitioner's sales by markup.

12 Using the purchase amounts reported on the FITR's, the Department made adjustments for  
13 supplies and mixes included, self consumption and complimentary drinks, and pilferage and shrinkage  
14 losses, to establish audited bar costs to be marked up. The Department established audited taxable bar  
15 purchase ratios for call and well liquor, regular and premium bottled beer, and draft beer, based on its  
16 review of second quarter 2005 (2Q05) purchase invoices. The Department computed the weighted  
17 markup applicable to periods through 1Q04, and computed a separate weighted markup for periods  
18 beginning 2Q04, when, according to petitioner, the prices were increased. For call and well drinks, the  
19 Department used pour sizes of 1½ ounces for most drinks and 3 ounces for cocktails (for certain  
20 liquors 90 percent were considered sold in 3-ounce cocktails and 10 percent were considered sold in  
21 1½-ounce regular drinks; overall, more than 20 percent of all liquor was treated as sold in 3-ounce  
22 cocktails and specialty drinks), and a 12-percent allowance was made for over pouring and spillage.  
23 The Department made a 1-percent allowance for breakage of bottled beer, and for draft beer used a 16-  
24 ounce pour (no pitchers were sold), with a 10-percent allowance for over pouring and spillage. The  
25 Department estimated that 75 percent of drinks were sold at entertainment prices and 25 percent were  
26 sold at regular prices for all categories. In sum, the Department computed weighted taxable markups  
27 of 360.39 percent for the period 2Q03 through 1Q04 and 399.12 percent for the period 2Q04 through  
28 1Q06.

1 The Department applied the weighted taxable markups to the audited bar costs to be marked up,  
2 made adjustments for sales taxes included, compared the audited taxable bar sales with reported  
3 taxable sales, and computed percentage-of-error understatements of 8.51 percent for 2003, 16.84  
4 percent for 1Q04, 26.66 percent for 2Q04 through 4Q04, and 37.34 percent for 2005. The Department  
5 accepted petitioner's reported taxable sales for 2003 because the error rate of 8.51 percent is within the  
6 10-percent tolerance considered acceptable under Board policy. (Sales and Use Tax Audit Manual,  
7 § 0802.65.) The Department applied the other error rates to reported taxable sales (the error rate for  
8 2005 was used for 1Q06) to establish understated taxable bar sales of \$309,271 for the audit period,  
9 representing an overall error rate of 23.44 percent.

10 Petitioner contends that the audited amount of taxable sales is overstated because: 1) the ratio  
11 of beer sold at regular prices is higher than the 25 percent allowed in the audit; 2) the pour size for  
12 regular drinks should be increased to 2 ounces; and 3) the audited cost of bar sales should be reduced  
13 to reflect an increase in inventory of \$15,000.

14 Regarding the ratio of beer sold at regular prices, petitioner argues that the Department's one-  
15 day observation is not representative. As support, petitioner has provided a 3-day tally by his  
16 bartenders that show over 70 percent of beer sales were at regular prices. We note that petitioner's test  
17 was not supervised and is not supported by any documentation; that petitioner's entertainment pricing  
18 is in effect for two-thirds of the total hours of operation of the business; and that petitioner initially  
19 indicated on the bar fact sheet that 95 percent of his sales occurred during periods of entertainment.  
20 We also expect there are more customers present, and thus more sales made, when the entertainment is  
21 provided. We conclude that the Department was being reasonable, if not generous, when it estimated  
22 that 25 percent of petitioner's sales were made at regular prices, and we find that such sales ratio  
23 should not be increased.

24 With respect to petitioner's assertion that the pour size for regular well and call drinks should  
25 be increased from 1½ to 2 ounces, petitioner conducted a demonstration at the appeals conference. He  
26 filled a 4-ounce rocks glass with ice, poured a drink to the top of the glass, then immediately poured  
27 out and measured the liquid at exactly 2 ounces. We do not find the demonstration persuasive because:  
28 1) some of the measured liquid represents melted ice; 2) petitioner listed 1½ ounces as his average



1 significant, and noted that this was petitioner's third consecutive audit on which a material error was  
2 noted. We found that the audit deficiencies established in the first two audits of petitioner were  
3 relatively minor (under 10 percent error), that petitioner had corrected one of the primary errors in  
4 those audits (reporting of self-consumption) for this audit period, and that petitioner's books and  
5 records provided for this audit were relatively complete for sales and use tax purposes. We gave  
6 petitioner the benefit of doubt for this audit period, concluding that he was not negligent, and  
7 recommended that the negligence penalty be deleted.

8 **OTHER DEVELOPMENTS**

9 None.

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11 Summary prepared by Pete Lee, Business Taxes Specialist II  
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**MARKUP TABLE**

Percentage of taxable vs. nontaxable purchases	94%
Mark-up percentages developed	345% (2Q03-1Q04) 399% (2Q04-1Q06)
Self-consumption allowed in dollars	\$4,000 per year
Self-consumption allowed as a percent of total purchases	3%
Pilferage allowed in dollars	\$7,405
Pilferage allowed as a percent of total purchases	2%