

**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:)
 S.J. TOONS, INC., dba Toons) Account Number: SR GH 26-830631
) Case ID 493139
 Petitioner)
 _____) San Jose, Santa Clara County

Type of Business: Cocktail lounge
 Audit period: 04/01/05 – 03/31/08

<u>Item</u>	<u>Disputed Amount</u>	<u>Tax</u>	<u>Penalty</u>
Unreported sales	\$888,487		
Negligence penalty	\$ 7,751		
As determined and proposed to be redetermined:		\$77,508.91	\$7,750.88
Less concurred		<u>- 3,875.45</u>	<u>0.00</u>
Balance, protested		<u>\$73,633.46</u>	<u>\$7,750.88</u>
Proposed tax redetermination		\$77,508.91	
Interest through 09/30/11		25,548.68	
Negligence penalty		<u>7,750.88</u>	
Total tax, interest, and penalty		110,808.47	
Payments		<u>- 19,055.30</u>	
Balance Due		<u>\$91,753.17</u>	
Monthly interest beginning 10/1/11		<u>\$292.27</u>	

This matter was scheduled for Board hearing on July 27, 2011, but was postponed at petitioner's request to allow additional time to prepare for hearing.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the amount of unreported sales. We find no adjustments are warranted.

Petitioner has operated a cocktail lounge since November 1991. In addition to its sales of beverages, petitioner has income from pool tables, video games, and cover charges. The Sales and Use Tax Department (Department) found that total sales reported on sales and use tax returns were

1 materially less than gross receipts reported on federal income tax returns for 2006 and 2007 and were
2 \$208,263 less than the sales recorded on petitioner's profit and loss statements for the audit period.
3 The Department regarded those discrepancies, as well as lower-than-expected book markups, as
4 evidence that reported taxable sales were understated, and it decided to establish audited taxable sales
5 on a markup basis.

6 The Department used two shelf tests to compute markups before and after a price change in
7 early 2007. Petitioner's bar fact sheet indicated that it did not have a happy hour during which it
8 offered reduced prices, but it did offer reduced prices for certain, varying periods during the evening.
9 Based on a review of cash register tapes for one week, the Department computed that 2.5 percent of
10 petitioner's sales were made at reduced prices, but the Department decided to apply a 5 percent
11 reduced price sales ratio. The Department computed weighted average markups of 417.54 for 2005
12 and 2006 and 420.13 percent for 2007. In computing the markups, the Department used a pour size of
13 1.5 ounces for liquor, plus 12 percent for over-pouring and spillage; a pour size of 6 ounces for wine,
14 plus 6 percent for over-pouring and spillage; and a pour size of 12 ounces for draft beer, with a 10
15 percent allowance for waste and spillage. To establish the audited costs of goods sold, the Department
16 used recorded merchandise purchases, exclusive of mixers, adjusted for beginning and ending
17 inventories. It reduced those recorded amounts by audited costs of self-consumed merchandise (based
18 on the recorded retail amount of drinks given away and on recorded numbers of redeemed free drink
19 tokens) of \$12,413 for 2005, \$20,400 for 2006, and \$17,043 for 2007, which represent 4.5 percent, 7.7
20 percent, and 6.7 percent of cost of goods sold for 2005, 2006, and 2007, respectively. The Department
21 also reduced costs in all categories by 2 percent for pilferage and reduced the cost of bottled beer by an
22 additional 1 percent for breakage.

23 Petitioner contends that it reported the correct amount of taxable sales, arguing that its average
24 pour size for liquor was 2 ounces, not the 1.5 ounces used in the audit, and that its pour size for draft
25 beer was 16 ounces, not the 12 ounces used in the audit.

26 We have reviewed the audit workpapers and have found no errors or inconsistencies that would
27 result in a reduction to the audited cost of goods sold. The Department made allowances for over-
28 pouring, spillage, breakage, and pilferage, at the rates recommended in Chapter 8 of the Audit Manual,

1 and an allowance for self-consumption that significantly exceeds the Audit Manual's minimum. The
2 pour sizes used in the audit were based on information provided in the bar fact sheet by petitioner's
3 outside accountant. Further, the pour size for liquor was supported by the results of an undercover
4 pour test. Petitioner now asserts that the accountant provided some incorrect information, and that
5 petitioner conducted a three-day test based on a 2-ounce pour size, computing the amount of liquor
6 sales for the three days of \$5,236.15. For the same three days, the cash register tapes show liquor sales
7 of \$4,327.75, and petitioner explains the \$908.40 difference as the result of self-consumption,
8 pilferage, special discount prices, and upgrading drinks (call liquor drinks provided at well liquor
9 prices). Petitioner has not provided a reconciliation to support this theory regarding the difference.
10 For the reasons explained in the D&R, we do not believe that drinks were upgraded (a practice denied
11 by petitioner's bartenders), especially not the 79 percent of well drinks reflected by petitioner's
12 calculations.

13 We find that the bar fact sheet and the undercover pour test, which support the audited pour
14 size of 1.5 ounces, provide significantly more reliable evidence than petitioner's computations. With
15 respect to the pour size for draft beer, the bar fact sheet lists the glass size for draft beer as 12 ounces,
16 and petitioner has provided no evidence to support an increase in the pour size for draft beer. We note
17 also that, as explained in the D&R, the Department made an error in its calculations of the cost of
18 drinks given away by bartenders that favored petitioner. In sum, we find that no adjustments are
19 warranted.

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

21 The Department imposed the penalty because it found that petitioner's records were inadequate
22 for sales and use tax purposes and the amount of understatement was significant. Petitioner disputes
23 the penalty primarily on the basis that it reported the correct amount of tax.

24 Petitioner has acknowledged that it did not maintain good internal controls over its inventory.
25 Further, the amounts of gross receipts reported on petitioner's federal returns exceeded the amounts
26 reported on sales and use tax returns by \$153,229 in 2006 and \$156,320 in 2007. In addition, the
27 understatement of reported taxable sales of \$888,487 represents an error rate of 37.8 percent in
28 comparison to reported taxable sales of \$2,353,501. We find that the lack of internal controls, the

1 substantial differences between amounts reported on federal returns and sales and use tax returns, and
2 the large error rate are evidence that the understatement was the result of negligence. We find that the
3 penalty was properly applied.

4 **OTHER DEVELOPMENTS**

5 None.

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7 Summary prepared by Thea Etheridge, Business Taxes Specialist II
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28**MARKUP TABLE**

Percentage of taxable vs. nontaxable purchases (bar purchases net of mixers)	100% taxable
Mark-up percentages developed	417.54% 2005-06 420.13% 2007
Self-consumption allowed in dollars	\$51,014
Self-consumption allowed as a percent of total purchases	4.5% for 2005 7.7% for 2006 6.6% for 2007
Pilferage allowed in dollars	\$14,970
Pilferage allowed as a percent of total purchases	2%