

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petition for Redetermination)
4 and Claim for Refund Under the Sales and Use)
5 Tax Law of:)6 NICKOLAOS PAPADOPOULOUS and)
7 DIMITRA PAPADOPOULOUS, dba)
8 Creekside Inn)Account Number: SR GH 26-746213
Case ID's 436833, 461505

9 Petitioner)

San Jose, Santa Clara County

10 Type of Business: Restaurant and bar

11 Audit period: 07/01/03 – 03/31/07

12 Item13 Disputed Amount

14 Unreported taxable sales

\$306,410

15 Unreported cost of self-consumed merchandise

\$ 705

16 Tax17 Penalty

18 As determined:

\$32,889.60

\$3,288.96

19 Adjustment - Sales and Use Tax Department

- 2,742.35

- 274.20

- Appeals Division

- 4,962.40

- 496.24

20 Proposed redetermination, protested

\$25,184.85\$2,518.52

21 Proposed tax redetermination

\$25,184.85

22 Interest through 11/30/09

10,305.73

10% penalty for negligence

2,518.52

23 Total tax, interest, and penalty

\$38,009.10

24 Payments

600.00

25 Balance Due

\$37,409.10

26 Monthly interest beginning 12/1/09

\$ 163.9027 **UNRESOLVED ISSUES**28 **Issue 1:** Whether further adjustments are warranted to the audited understatement of reported taxable sales. We recommend no further adjustment.

29 Petitioner operates a restaurant and bar. Petitioner rang its sales on a cash register and recorded sales from the cash register in a single-entry sales journal. The Sales and Use Tax Department (Department) used gross receipts and cost of goods sold recorded on federal income tax returns to compute achieved markups of 149.34, 174.71, and 178.70 percent for 2003, 2004, and 2005,

1 respectively. For the same respective years, petitioner reported net income on its federal returns of
2 \$28,919, \$28,539, and \$29,441. The Department concluded that further investigation was warranted
3 because the achieved markups were lower than expected for a restaurant and bar, and the reported
4 amounts of net income seemed inadequate to sustain a family living in San Jose.

5 The Department computed a separate achieved markup of 214 percent for food sales, which it
6 found reasonable. Consequently, the Department accepted recorded and reported food sales as
7 substantially accurate. However, the Department established audited bar sales on a markup basis,
8 using an audited markup of approximately 302 percent. The Department computed an understatement
9 of reported taxable sales of \$319,064 in the audit report dated June 1, 2007. However, petitioner
10 expressed concerns, and to address them, prior to issuing a Notice of Determination, the Department
11 agreed to conduct further tests. The Department observed petitioner's business operations for two full
12 days, Thursday, September 20, 2007, and Saturday, October 13, 2007. The Department calculated
13 ratios of credit card sales to total sales of 47.66 percent and 47.44 percent, respectively, for those days.
14 The Department prepared a revised audit in which the total understated measure was \$398,661. The
15 Notice of Determination was based on the findings of the revised audit.

16 Petitioner thereafter identified some errors in the Department's computations in the revised
17 audit. Upon correction of these errors, the Department recomputed and increased the credit card to
18 total sales percentage to 48.94 percent for Thursday, September 20, 2007, and 47.55 percent for
19 October 13, 2007, with an overall weighted average percentage of 48.05 percent. The Department
20 issued a pre-conference reaudit which reduced the understated taxable measure from \$398,661 to
21 \$365,420, comprised of understated reported taxable sales of \$361,415, unreported measure of taxable
22 self-consumption of \$9,360, and a credit measure of \$5,355 for unclaimed tax-paid purchases resold.

23 In our D&R, we recommend correction of some errors petitioner identified in the calculation of
24 tips included in credit card sales, reducing understated taxable sales \$361,415 to \$306,149. However,
25 in applying this recommendation, the Department noted a calculation error that results in slight
26 adjustment, to understated taxable sales of \$306,410, which we agree is the correct figure and which is
27 the amount in dispute. Petitioner contends that there was no understatement of reported taxable sales.
28

1 Petitioner contends that the two-day site test was not sufficiently long and was not
2 representative of sales during the audit period. The Department observed the business for one full
3 weekday and one full weekend day. An observation test of two days is typical in the Department's
4 audit procedures. (See, e.g., Audit Manual section 0810.12.) Petitioner contends that its actual
5 percentage of credit card sales to total sales varied dramatically from day to day, based on its recorded
6 sales for the first six months of 2005. Based on our review of the figures on which petitioner relies, we
7 do not view them as having fluctuated drastically. Furthermore, we find the similarity between the
8 percentage found for each test day to be strong evidence that the 48.05 percent ratio is representative,
9 and we reject petitioner's assertion that any similarity between the percentages for the two test days is
10 entirely coincidental.

11 Petitioner asserts that the site-tests were not representative because the percentage of credit card
12 sales to total sales decreased in 2005 when an automated teller machine (ATM) was installed in the
13 restaurant. Petitioner argues it is "self-evident" that the presence of a stand-alone ATM in the
14 restaurant decreased the use of credit cards. Thus, even if the 48.05 percent ratio were valid for
15 periods after installation of the ATM (which petitioner has not conceded), petitioner asserts that the
16 ratio for periods prior to the installation of the ATM would have been higher, and, based on
17 computations using its recorded sales for the first six months of 2005, petitioner contends that the
18 audited ratio credit card sales to total sales should be increased from 48.05 percent to 60.8 percent.

19 For one thing, even if petitioner were correct, using sales figures for periods *prior* to the ATM
20 installation which it contends altered the ratio of credit card sales to develop a ratio also applicable to
21 periods *after* that installation is just as faulty as applying a ratio developed after the installation to
22 periods before the installation. However, we reject petitioner's proposed method even for periods prior
23 to the installation of the ATM. First, petitioner has calculated the figure based solely on its records.
24 That is, petitioner attempts to validate recorded and reported amounts using the recorded figures
25 themselves. However, using petitioner's federal income tax returns (which, presumably, were
26 completed based on petitioner's records), the Department concluded that the achieved markups were
27 lower than expected for a restaurant and that further investigation was warranted. The Department
28 performed an audit to evaluate the accuracy of recorded and reported taxable sales. Petitioner, instead,

1 seeks to use its records to validate those very records. We reject this approach. Nor has petitioner
2 provided any actual basis for concluding that the installation of the ATM resulted in any significant
3 change in the credit card to total sales ratio. The possibility that the ATM could have had some effect
4 is insufficient for us to conclude that the ratio developed by the Department requires further adjustment
5 in the absence of any valid evidence in support of such adjustment.

6 We find that the disputed deficiency was properly calculated by the Department using a valid
7 audit method, and that petitioner has provided no basis for adjustment.

8 **Issue 2:** Whether further adjustments are warranted to the audited cost of self-consumed
9 taxable merchandise subject to use tax. We recommend no further adjustment.

10 During the audit, the Department computed an audited cost of self-consumed beverages of
11 \$9,360 using estimates provided by petitioner's CPA of 24 drinks per week, about four per day, and an
12 average cost per drink at \$2.00. Petitioner contended at the conference that the number of drinks
13 should be reduced to 20 per week, and the average cost per drink should be reduced to \$0.90.
14 Petitioner calculates that the cost of self-consumed merchandise should be reduced to \$3,510.

15 We find that there is no basis for reducing the estimated number of drinks given away, but we
16 agree that the average cost per drink should be reduced to \$0.90. Thus, we conclude that the cost of
17 self-consumed merchandise should be reduced to \$4,215 and we recommend no further adjustments.

18 **Issue 3:** Whether petitioner was negligent. We conclude that it was.

19 Petitioner protests the negligence penalty, stating that its records were adequate for this type
20 and size of business, and asserting that the understatement of reported taxable sales is excessive.

21 Petitioner correctly states that the *types* of records it provided are adequate for this type and
22 size of business, *if* those records are completely and accurately maintained. However, there is ample
23 evidence that the amounts of sales recorded in petitioner's records were incomplete, and that petitioner
24 did not exercise due care in record-keeping. We note that petitioner was previously audited for the
25 period October 1, 1998, through June 30, 2001, during which errors were identified resulting from
26 incomplete and inaccurate recordkeeping. Those same types of errors were found in this audit period.
27 We note also that the understatement of \$305,270 ($\$306,410 + \$4,215 - \$5,355$) represents an error rate
28 of 16 percent ($\$305,270 \div \$1,906,010$ reported), which is sufficiently significant to represent

1 negligence. Accordingly, we find that the understatement was the result of negligence, and that the
2 penalty was properly applied.

3 **RESOLVED ISSUE**

4 Petitioner filed a claim for refund, stating that it had paid sales tax reimbursement of \$442 on
5 the purchase of merchandise for \$5,355 that it had subsequently resold without making any intervening
6 use. The Department investigated petitioner's claim and concluded that it had made an overpayment
7 of \$442. The claim for refund, filed July 23, 2008, was timely only for the period April 1, 2005,
8 through March 31, 2007. However, since there were audited deficiencies throughout the audit period,
9 the Department offset the overpayments for the time-barred period (July 1, 2003, through March 31,
10 2005) against audited deficiencies for the same periods. Thus, the entire amount of overpayment
11 claimed has been allowed in the audit.

12 **OTHER DEVELOPMENTS**

13 None.

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