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:	
SOFTBYTE, LLC	Account Number: SR GH 100-150473 Case ID 436211
Petitioner	Menlo Park, San Mateo County

Type of Business: Restaurant

Audit Period: 1/1/04 – 12/31/06

Item	Disputed Amount
Unreported taxable sales	$167,614

	Tax	Penalty
As determined	$15,483.10	$1,548.32
Adjustment: Sales and Use Tax Department	- 328.43	- 32.81
Appeals Division	- 1,326.46	-1,515.51
Proposed redetermination, protested	$13,828.21	$ 0.00
Proposed tax redetermination	$13,828.21	
Interest through 5/31/09	4,698.27	
Total tax and interest	$18,526.48	
Monthly interest beginning 6/1/09	$92.19	

UNRESOLVED ISSUE

Issue: Whether additional adjustments are warranted. We conclude that no further adjustments are warranted.

Petitioner, a limited liability company, started business in February 2003, operating a restaurant and a software consulting business. The restaurant business originally operated as a fine dining restaurant, but was closed for approximately one month for remodeling during the first quarter 2006 (1Q06) to convert to a cafeteria-style restaurant. This was petitioner's first audit.

For audit, petitioner provided federal income tax returns (FITR's), bank statements, and purchase invoices. The Sales and Use Tax Department (Department) found that the gross receipts reported on the FITR's were substantially more than the reported sales to the Board, but accepted that differences represented income from petitioner's software consulting business. The Department also found that the bank deposits exceeded reported sales to the Board, but again accepted that the differences represented petitioner's the nontaxable income from its software consulting business and other non-sale income. However, the Department did not accept that the gross receipts reported on the FITR's were accurate, noting that petitioner reported a net loss of $105,271 on its FITR for 2004, and net incomes on its FITR's for 2005 and 2006 of just $8,149 and $2,652, respectively, and showed no compensation to officers or members of the limited liability company. The Department also calculated achieved markups of 185 percent for 2004 and 308 percent for 2005 based on total sales reported on petitioner's sales and use tax returns and costs of goods sold reflected on its FITR's.[1] While the Department considered the achieved markups for 2004 and 2005 to be within an acceptable range for petitioner's type of business, the large difference in the achieved markups for each year required further investigation, especially since costs could not be verified due to the lack of available purchase invoices. For these reasons, the Department decided to establish petitioner's sales based on a credit card analysis.

The Department observed petitioner's business for two days, Thursday, July 5, 2007, and Tuesday, October 2, 2007, and recorded all sales made for those days. Based on the site test, the Department established that credit card sales represented 65.24 percent of total sales. Since the business changed during 1Q06, the Department determined the credit card ratio was applicable to the period 2Q06 through 4Q06, and used this period as a test period in the audit. For those three quarters, the Department took credit card deposits from petitioner's bank statements, adjusted for tips and sales tax included, to compute credit card sales. The credit card sales amount was then divided by the credit card ratio of 65.24 percent to establish audited taxable sales and compared those amounts to reported taxable sales. Using this method, the Department calculated a credit measure of $5,594 for 2Q06, and deficiencies measured by $19,612 for 3Q06 and $44,416 for 4Q06. The Department decided it was unlikely that petitioner over-reported its actual taxable sales for 2Q06, and for these purposes therefore adjusted the error for that quarter to $0. Based on these results, the Department calculated that

[1] The Department was unable to use this method to calculate an achieved markup for 2006 because merchandise purchases were included in "other deductions" on petitioner's FITR for that year.

petitioner had underreported its taxable sales by 16.37 percent for the test period. This percentage was applied to 1Q04 through 1Q06, which was added to the actual audited errors for the test period to establish total understated taxable sales of $183,692 for the audit period.

We conclude that the audited overreporting for 2Q06 could have represented timing differences, and that it should thus remain in the calculations. We therefore conclude that the appropriate error rate is 14.94 percent, which results in underreported taxable sales of $167,614.

Petitioner contends that when the business was a sit-down restaurant, the credit card ratio and tip ratio were much higher; therefore, the observed ratios should not be applied to periods prior to 2Q06. Petitioner states that the ratios of cash sales and credit card sales can vary substantially from day to day. Petitioner notes that the two observed days showed credit card ratios which varied significantly, 59.15 percent for July 5, 2007 compared to 70.43 percent for October 2, 2007. Petitioner believes the observed credit card ratio for October 2, 2007, is more representative of its business operations.

Petitioner did not provide complete or accurate records for audit, and we thus find that the Department was justified in using the indirect audit method it chose to compute petitioner's taxable sales. Petitioner has not provided any evidence to show that the average credit card ratio of the two tested days is too low. We agree that the credit card ratios would likely differ for periods prior to and after the remodeling of the restaurant. However, the Department did not apply the credit card ratio to periods prior to 2Q06. Rather, the Department only applied the credit card ratio to the periods after the conversion of the restaurant to establish credit card sales for those periods that in turn was used to calculate the percentage of underreporting. It then applied the percentage of underreporting to the earlier portions of the entire audit period. The theory for this approach is that the percentage of error in reporting would have been similar throughout the audit period, whether or not the credit card ratio remained static. In the absence of evidence to the contrary, we believe this approach is valid, and we therefore recommend no adjustments other than to reduce the measure of deficiency to $167,614.

RESOLVED ISSUE

We have found that the negligence penalty should not apply. Petitioner provided some records, specifically income tax returns and bank statements, which would have been useful to help establish petitioner’s taxable sales if income from petitioner’s consulting business had not been commingled. This is petitioner’s first audit, and an error rate of 14.94 is not exorbitantly high for this type of business under these circumstances. Accordingly, we conclude it is appropriate to give petitioner the benefit of the doubt and remove the negligence penalty.

OTHER DEVELOPMENTS

None.

Summary prepared by John K. Chan, Business Taxes Specialist I