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: FRANCISCO HALAYAY JR., dba Cozy Cup Cafe Petitioner	Account Number SR GHC 100-039667 Case ID 569173 Hollister, San Benito County

Type of Business: Restaurant

Audit period: 07/01/06 – 06/30/09

Item	Disputed Amount
Unreported taxable sales	$283,607
Negligence penalty	$ 2,221

Tax as determined and protested	$22,208.63
Interest through 09/30/13	8,712.66
Negligence penalty	2,220.87
Total tax, interest, and penalty	$33,142.16
Less payment	- 125.46
Balance Due	$33,016.70
Monthly interest beginning 10/01/13	$ 110.42

UNRESOLVED ISSUES

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

Petitioner has operated a restaurant serving breakfast and lunch seven days a week since December 2001. For audit, petitioner provided copies of his federal income tax returns, monthly sales summaries, bank statements, cash register Z-tapes for September 23, 2009, and October 3, 2009, and guest checks and detailed cash register tapes for two weeks in October 2009 and a week in March 2010. The Sales and Use Tax Department (Department) compared petitioner's reported total sales to his bank deposits, net of sales tax reimbursement, and to the gross receipts reported on his federal income tax returns, and found only minimal differences. The Department then compared petitioner's reported gross receipts with the reported costs of goods sold on the income tax returns, and computed book markups of 186 percent, 249 percent, and 167 percent for 2006, 2007, and 2008, respectively. Since the book markups were inconsistent and lower than expected, the Department decided to establish audited taxable sales from the cash register Z-tapes provided by petitioner. The cash register Z-tape for September 23, 2009, included a summary of total sales since the register was put into operation, along with the number of days the register was used. The Department used the cumulative sales total of $888,516 and the 805 days the cash register had been used, as shown on the Z-tape, to compute an average of $1,104 per day. After computing that petitioner put the cash register into operation on July 1, 2007, the Department multiplied $1,104 by 90 days to compute audited total sales of $99,337 per quarter for the two-year period from July 1, 2007, through June 30, 2009. The Department then computed audited taxable sales, net of sales tax reimbursement, of $735,858 for that two-year period. The Department compared audited taxable sales with reported taxable sales of $540,407 for the same period to compute unreported taxable sales of $195,451, and a reporting error rate of 36.17 percent. The Department then multiplied reported taxable sales for the audit period by 36.17 percent to establish total unreported taxable sales of $283,607.

To verify the accuracy of the total sales shown in the cash register Z-tape, the Department performed site observation tests on September 23, 2009, and October 3, 2009, and used the results of these tests, which showed ratios of credit card sales to total sales of 36 percent and 45 percent, respectively, to prepare a credit card sales ratio analysis. Petitioner argued that his credit card sales ratio typically was higher than those observed by the Department, and asked the Department to perform more testing. Petitioner provided cash register tapes for the week of March 15, 2010, through March 21, 2010, which showed an average credit card sales ratio of 57 percent for the seven days. The Department performed another site observation test on March 19, 2010, and verified that petitioner was ringing up his sales correctly, but since the Department was unable to verify the recorded sales for every day in the one-week test, the Department weighted the average ratio of 57 percent equally with the two ratios from the first observation tests, and computed an average credit card sales ratio of 46 percent [(36 + 45 + 57) ÷ 3]. Results of the analysis using this credit card sales ratio and credit card deposits for the audit period showed unreported taxable sales of $372,649. Although this analysis seemed to indicate that the sales recorded in the cash register Z-tape might have been incomplete, the

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

Department decided that this analysis was not sufficiently reliable to establish audited taxable sales due to the high variability of the daily credit card ratios, which ranged from 36 percent to 67 percent in the nine days tested. Therefore, the Department concluded that the cumulative sales shown on the cash register Z-tape for September 23, 2009, constituted the most reliable evidence of petitioner's sales during the audit period.

On appeal, petitioner claims that the total sales shown in his cash register Z-tapes are inaccurate because he did not know how to correct ring-up errors or void sales on the cash register. Petitioner's wife, Wendy Halayay, provided a declaration, signed under penalty of perjury, that prior to the audit, none of the five people authorized to operate the cash register had formal training or instruction on all of its functions, including how to cancel out erroneous entries. According to Ms. Halayay, she made handwritten entries on the cash register tapes when she noted ring-up errors during her daily reconciliation of the daily totals from the cash register tapes with the totals of the guest checks. At the appeals conference, petitioner agreed to determine whether documentation showing the ring-up errors was available, and to try to estimate his average monthly ring-up errors. However, petitioner subsequently provided only one sample cash register tape with a handwritten note about an error. Petitioner stated that four errors totaling $155 had occurred during November 2012, but indicated that ring-up errors were not a standardized problem, and therefore, it was impossible to estimate the average errors that occurred on a monthly basis.

Petitioner contends that his sales should be computed based on another credit card sales ratio analysis using a credit card sales ratio of 53.21 percent, which petitioner calculates by giving equal weight to the credit card sales ratio for each day in the one-week test, as well as the two earlier days that the Department observed. Using the credit card sales ratio of 53.21 percent, petitioner calculates unreported taxable sales of $215,783. Petitioner further contends that, if audited sales are established based on average daily sales, the average daily sales amount should be reduced from $1,104 to $825, based on all of the documented daily sales, including the sales shown in the guest checks and detailed cash register tapes for two weeks in October 2009 and one week in March 2010. Additionally, petitioner contends that a comparison of audited taxable sales with his recorded costs of goods sold shows an excessive markup percentage, which shows that audited taxable sales are overstated.

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

According to petitioner, his markup probably is lower than similar businesses because he operates a small café in the 12^{th} most economically-stressed county in the nation, and therefore is unable to charge industry-average markups and remain in business, and he uses higher quality ingredients.[1]

Regarding petitioner's assertion that his cash register Z-tapes do not account for voids or errors in ringing up sales, petitioner has provided no documentation showing that he failed to correctly account for voided sales and ring-up errors, even though such documentation was specifically requested. Furthermore, we note that, if the sales shown in the Z-tape were overstated due to errors in ringing up sales, and petitioner's reported sales were accurate, the reporting error rate of 36.17 percent computed in the audit would seem to indicate an unreasonable number of errors in ringing up sales. Therefore, we find no adjustment is warranted for alleged ring-up errors on the cash register tapes. Since petitioner has not shown that a credit card sales ratio analysis would reflect his sales more accurately than his own cash register records, we reject petitioner's argument that a different method should be used to establish audited sales. Petitioner also has not shown why average daily sales for a few days after the end of the audit period represent his sales for the audit period more accurately than the sales recorded in his cash register for two years of the audit period. Our comparison of audited taxable sales of $1,067,770 for the period July 1, 2006, through June 30, 2009, with petitioner's reported costs of goods sold of $257,933 for the period January 1, 2006, through December 31, 2008, shows a markup of 314 percent, which we find is reasonable for this business. We find that the sales recorded in petitioner's cash register form the most reliable basis for audited taxable sales, irrespective of any secondary tests or alternate audit methods. Given that petitioner has not provided any evidence showing that his recorded sales are unreliable, we conclude that no adjustments are warranted.

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

The Department imposed the negligence penalty because petitioner did not maintain source documents, such as guest checks or cash register tapes, to support his reported sales, and because the

---

[1] Petitioner also raises objections to certain secondary tests that are not addressed in the D&R. For example, petitioner disputes the Department's projection of a one-hour test on August 14, 2009, and disputes the validity of a reasonableness test showing that his reported income is insufficient to support his family. However, these tests were not used to establish audited taxable sales; they were offered by the Department only as secondary support of the audit findings. Therefore, we find that petitioner's objections to those tests do not impact our analysis of the audit results.

understatement is substantial, as evidenced by a reporting error rate of 36 percent. Petitioner asserts that he reported exactly what his guest checks showed, and suggests that his cook was covering up theft by ringing up sales without a corresponding guest check. Petitioner claims that, once the cook was fired, the guest check totals matched his cash register Z-tapes. Petitioner contends that he was not negligent because he tried to report accurately. Additionally, petitioner points out that this was his first audit, and claims that he has taken measures to report his sales accurately in the future.

Since petitioner claims that he used guest checks to report his sales, we find that petitioner's failure to maintain the guest checks for any portion of the audit period is evidence of negligence in recordkeeping. We also find that the reporting error rate of 36 percent is evidence of negligence in reporting. Petitioner has provided no evidence showing that his cook rang up sales without a guest check, or that guest check totals did not match the cash register Z-tapes. We note that the declaration from Ms. Wendy Halayay states that she reconciled the guest check totals with the cash register Z-tapes on a daily basis. If the totals did not match on a regular basis, we would expect Ms. Halayay to take immediate steps to determine the source of the discrepancies and take corrective actions. Therefore, we find that petitioner's failure to determine the cause of any discrepancies in his records and take corrective actions is additional evidence of negligence. Accordingly, we find that petitioner was negligent and the penalty was properly imposed, even though petitioner had not been audited previously.

OTHER MATTERS

None.

Summary prepared by Lisa Burke, Business Taxes Specialist III