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:

LA MORDIDA INC.

Petitioner

Account Number: SR X GH 100-055635
Case ID 470304

San Jose, Santa Clara County

Type of Business: Restaurants

Audit period: 01/01/04 – 12/31/06

Item	Disputed Amount
Unreported taxable sales	$144,404
Negligence penalty	$ 5,355

	Tax	Penalty
As determined:	$65,316.36	$6,531.62
Adjustment - Sales and Use Tax Department	- 11,766.34	- 1,176.62
Proposed redetermination	$53,550.02	$5,355.00
Less concurred	- 41,636.67	00.00
Balance, protested	$11,913.35	$5,355.00

Proposed tax redetermination	$53,550.02
Interest through 7/31/11	19,879.68
Negligence penalty	5,355.00
Total tax, interest, and penalty	$78,784.70
Payments	- 45,619.39
Balance Due	$33,165.31
Monthly interest beginning 8/1/11	$ 39.65

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the unreported taxable sales. We find no further adjustments are warranted.

During most of the audit period, petitioner operated two restaurants, and it added a third restaurant in October 2006. The restaurants sold hot food, carbonated beverages, and beer. Petitioner recorded its total sales from cash register Z-tapes into monthly journals, which it used to prepare sales and use tax returns. Petitioner provided incomplete records for audit.

The Sales and Use Tax Department (Department) used the amounts of sales and cost of goods sold on petitioner's federal income tax returns to compute book markups of 138 percent for 2004 and 128 percent for 2005, which were lower than the minimum markup of 200 percent the Department expected for this business. To establish audited sales, the Department used average daily sales computed from petitioner's cash register Z-tapes for the two locations that were in business throughout the audit period (petitioner provided cash register tapes for the period November 7, 2004, through October 19, 2006, for one location and for the period June 3, 2004, through December 31, 2004, for the second location).[1] After adjustments in a reaudit to reduce the audited sales for sales tax included, the audited understatement for the period January 1, 2004, through September 30, 2006, is $649,090. The Department found that petitioner's reported taxable sales of $192,369 for the fourth quarter 2006 were substantially accurate, since the amount was consistent with the Department's computed amount of $192,487 for the same quarter (comprised of computed sales for the first two locations and recorded sales for the third location, which was added in October 2006).

Petitioner contends that the computed amount of average daily sales for the second location is excessive because it was based on a review of cash register Z-tapes for only 212 days. Petitioner asserts that the test of recorded sales for the second location should be expanded to include recorded sales for the periods October 9, 2007, through November 1, 2007, and May 1, 2008, through December 31, 2008. Based on its review of the cash register tapes for those periods, petitioner computed a lower average amount of daily sales for the second location and computed an understatement of reported taxable sales of $504,686, which is $144,404 lower than the amount of $649,090 computed by the Department.

Petitioner has suggested that cash register tapes from long after the audit period should be used to compute average daily sales during the audit period. In general, recorded sales during the audit period are more reliable indicators of average daily sales *during the audit period* than recorded sales

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[1] The Department had first conducted observation tests and used a credit card sales ratio analysis to establish an understatement of reported taxable sales of $439,656. Upon further review, however, the Department concluded that the results of its observation tests were not reliable since petitioner's sales on the observation days were significantly lower than its recorded average sales.

for periods long after the audit period. At the same time, expansion of a test period generally increases the level of reliability of the test results. In this case, in order to evaluate the reliability of the audited amount of average daily sales, we have analyzed the amount of reported taxable sales for the fourth quarter 2006, which has been accepted as substantially accurate. In that regard, we note that petitioner substantially increased the amount of taxable sales it reported after the Department contacted it on October 7, 2006, regarding the upcoming audit. We find this increase is evidence that petitioner took extra care to accurately report its sales for the fourth quarter 2006, in preparation for the audit. As noted previously, for the fourth quarter 2006, petitioner reported taxable sales of $192,369, and the amount computed by the Department for that quarter was $192,487. We find the remarkable consistency between those figures to be strong evidence of the accuracy of audited taxable sales. Further, using petitioner's lower computed amount of average daily sales would result in taxable sales less than petitioner reported for the fourth quarter 2006, but petitioner has not explained how it might have over-reported its taxable sales for that quarter.

We find that the accuracy of audited taxable sales for the audit period would not be enhanced by expanding the test of recorded sales to include periods long after the end of the audit period.

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

The Department imposed the negligence penalty because petitioner's records were inadequate for sales and use tax purposes, and the understatement of reported taxable sales is significant. Petitioner disputes the penalty on the basis that it was not negligent in keeping records or in reporting. With respect to record-keeping, petitioner states it had maintained daily sales summaries, but it lost the binder containing those summaries when it sold one of the restaurant locations. With respect to reporting, petitioner asserts that the amount of understatement is excessive, and that the correct amount is not evidence of negligence.

We find that petitioner's records were incomplete, which is evidence of a lack of due care in record-keeping. We also note that the understatement of $649,090 represents an understatement of 51.18 percent. That understatement is substantial, and is additional evidence of negligence. Moreover, we note that petitioner accurately reported its sales for the fourth quarter 2006, which is evidence that it had the resources and knowledge to prepare accurate returns. Regarding petitioner's assertion that the “correct” understatement is not sufficiently large to be evidence of negligence, we note petitioner has computed an understatement of reported taxable sales of $504,686, which represents an error of almost 40 percent in comparison with reported taxable sales of $1,268,151. We find that conceded amount of understatement to be substantial, and sufficient to represent evidence of a lack of due care taken to accurately report. For all these reasons, we find the understatement was the result of negligence, and the penalty was properly applied.

OTHER DEVELOPMENTS

None.

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