

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matters of the Petitions for Redetermination)
 4 and Claim for Refund Under the Sales and Use Tax)
 4 Law of:)

5 WILLIAM G. MORSCHAUSER)
 6 dba Friar Tuck's Bar & Grille)

7 Petitioner/Claimant)

Account Number: SR AP 17-811203
 Case ID's 255762, 341121, 225366

Rancho Cucamonga, San Bernardino County

8 Type of Business Cocktail lounge

9 Claim Period 1/01/97 – 12/31/99 (case ID 225366)

10 Audit Period 10/01/00 – 12/31/03 (case ID's 255762, 341121)¹

11 <u>Item</u>	<u>Amount in Dispute</u>
12 Unreported taxable bar sales	\$1,067,343 (255762, 341121)
13 Unreported taxable sales of food	\$ 52,897 (255762, 341121)
14 Fraud penalty	\$ 12,254 (255762, 341121)
14 Claim for refund	\$ \$30,766 (225366)

	<u>255762</u>		<u>341121</u>	
	<u>Tax</u>	<u>Penalties</u>	<u>Tax</u>	<u>Penalties</u>
15 As determined	\$28,761.76	\$2,876.19	\$72,704.68	\$29,123.65
16 Pre-D&R adjustment	<u>- 8,661.80</u>	<u>+2,148.82</u>	-	<u>-21,894.77</u>
17 Adjustment for tax paid under amnesty			<u>- 43,789.42</u>	
18 Proposed redetermination	\$20,099.96	\$5,025.01	\$28,915.26	\$ 7,228.88
19 Amount concurred in	<u>- 247.97</u>		<u>- 909.89</u>	
20 Protested	<u>\$19,851.99</u>	<u>\$5,025.01</u>	<u>\$71,794.79²</u>	<u>\$ 7,228.88</u>
21 Proposed tax redetermination	\$20,099.96		\$28,915.26	
22 Interest through 07/31/13	20,828.89		22,260.87	
23 Fraud penalty	<u>5,025.01</u>		<u>7,228.88</u>	
24 Total tax, interest, and penalty	<u>\$45,953.86</u>		<u>\$58,405.01</u>	
25 Payments			<u>- 1,546.18</u>	
26 Balance			<u>\$56,858.83</u>	
27 Monthly interest beginning 08/01/13	<u>\$ 100.50</u>		<u>\$ 136.85</u>	

26 ¹ In order to avoid the passing of the statute of limitations for periods before July 1, 2001, the Sales and Use Tax
 27 Department issued two Notices of Determination for the audit period, for the periods October 1, 2000, through June 30,
 28 2001, and July 1, 2001, through December 30, 2003. The petitions for those periods have been assigned case ID's 255762
 and 341121, respectively.

² The protested amount includes the amount paid under amnesty and represents \$72,704.68 less \$909.89.

1 properly, and note that the allowances for pilferage of 4.48 percent for beer and 11.21 percent for
2 liquor are substantially higher than the standard allowance for pilferage of alcoholic beverages sold in
3 bars of 2 percent. Petitioner has provided insufficient evidence to support increases in the pilferage
4 allowances, and we find no further adjustments are warranted. Since the amount paid in excess of the
5 amount established in the reaudit has been refunded, we find that there is no remaining overpayment.

6 **Issue 2:** Whether adjustments are warranted to unreported taxable sales for the period
7 October 1, 2000, through December 31, 2003. We find no further adjustments are warranted.

8 The Department conducted an audit for the period October 1, 2000, through December 31,
9 2003, but it issued an NOD for the period October 1, 2000, through June 30, 2001 prior to completing
10 the audit to prevent the passing of the statute of limitations before it could do so. That NOD reflected
11 an understatement of tax of \$28,761.76 and negligence penalty of \$2,876.19. Petitioner filed a timely
12 petition for redetermination (case ID 255762). The Department thereafter completed the audit,
13 concluding that the tax for the earlier period should be reduced to \$20,099.96, but that the negligence
14 penalty should be replaced by a fraud penalty of \$5,025.01. The Department issued an NOD for the
15 remaining portion of the audit period, July 1, 2001, through December 31, 2003, for tax of \$72,704.68,
16 a fraud penalty of \$18,176.25, and an amnesty double fraud penalty of \$10,947.40. Petitioner filed a
17 timely petition for redetermination (case ID 341121).

18 Petitioner applied for amnesty, entered into an installment payment plan, and made installment
19 payments of \$61,224.87, that were sufficient to pay the tax and interest applicable to the amnesty-
20 eligible periods included in the second NOD. Thus, the Department waived the fraud penalty imposed
21 for the amnesty-eligible portion of the second NOD and the associated amnesty double fraud penalty,
22 reducing the fraud penalty in the second NOD to \$7,228.88.

23 For audit, petitioner provided only bank statements and copies of the sales and use tax returns,
24 as he had for the prior audit period, and the Department again established bar sales on a markup basis.
25 In its computations, the Department used the markups that had been computed for the most recent
26 reaudit of the prior period, which petitioner did not dispute. Beer and liquor purchases were obtained
27 from petitioner's vendors. To establish the audited cost of beer sold, beer purchases were reduced by
28 3 percent for self-consumption, 1 percent for breakage of bottled beer, 5 percent for waste of draft

1 beer, and by pilferage allowances of 4.48 percent for 2001, 2.62 percent for 2002, and 2 percent for
2 2003. To establish the audited cost of liquor sold, liquor purchases were reduced by 3 percent for self-
3 consumption, and by pilferage allowances of 11.21 percent for 2001, 4.3 percent for 2002, and
4 2 percent for 2003. The Department computed unreported bar sales of \$1,067,341 for the audit period.
5 Since petitioner did not provide any summary record of food sales, the Department used guest checks
6 for ten days to compute audited average food sales of \$45.22 per day, \$4,069 per quarter, and \$52,897
7 for the audit period.

8 Petitioner argues that the entire understatement for unreported bar sales should be deleted
9 because pilferage accounts for the entire difference between audited and reported bar sales. According
10 to petitioner, the bartenders were putting money customers gave them for drinks into tip jars instead of
11 into the cash register. Apparently, one of his bartenders (Lillian Sandoval) routinely served several
12 drinks without ringing any of the sales of drinks on the register. When the customer left for the
13 evening, he or she would leave money on the bar, and Ms. Sandoval would put it all in her tip jar.
14 Petitioner asserts that other bartenders observed her actions and began the same practice. Petitioner
15 argues that this process of serving drinks without placing the money for the drinks in the cash register
16 represents a theft of merchandise, and he estimates that such theft amounted to about \$2,500 to \$3,500
17 per week. Petitioner submitted statements signed under penalty of perjury from eight of his employees
18 and former employees and eight customers that this type of theft occurred in petitioner's business.

19 Petitioner also alleges that Ms. Sandoval was stealing merchandise (in addition to cash), and he
20 has provided an analysis of merchandise purchases showing that his merchandise purchases were
21 greater during the month prior to Ms. Sandoval's termination than during the month following her
22 termination. Petitioner also argues that merchandise purchases should be reduced by 5 percent to
23 account for merchandise that he returned to his vendors. In addition petitioner argues that the amount
24 of audited food sales is excessive, but he has provided neither a specific argument nor documentation
25 to support an adjustment of audited food sales. Finally, petitioner argues that bank deposits should be
26 used to compute the audit liability, stating that bank deposits were used to prepare returns.

27 First, we find petitioner has not shown that there were thefts of the magnitude he describes.
28 Based on our rough calculations, the amounts of pilferage petitioner alleges would represent about

1 42 percent of the beer and liquor purchased by petitioner during the period January 1, 1997, through
2 December 31, 1999, and about 59 percent of the beer and liquor purchased by petitioner during the
3 period October 1, 2000, through December 31, 2003. We do not accept that petitioner suffered this
4 magnitude of theft over this length of time without being aware of it. Regarding the alleged practice of
5 bartenders, stealing money customers left on the bar, those thefts would be thefts of money after the
6 sale, not thefts of merchandise. Petitioner's bartenders were authorized to make sales on his behalf,
7 and those sales occurred when one of the bartenders served a customer a drink and took money from
8 the customer as consideration for the sale, under petitioner's authority. That is, the sale was actually
9 made by petitioner, through his employee. If his employee *thereafter* improperly retained the sale
10 price, that improper act did not serve to negate the sale that had already occurred, nor petitioner's
11 liability for sales tax for that sale made of his property under his authority. Thus, no additional
12 adjustment for pilferage is warranted for petitioner's argument that his bartenders stole money after the
13 sale was made. With respect to additional allowances for actual for thefts of merchandise, the
14 Department has made allowances greater than the standard pilferage allowance of 2 percent for periods
15 prior to 2003, the last year of the audit period. We note that it made those large allowances, even
16 though audited purchases may be incomplete since petitioner did not provide a summary record of
17 merchandise purchases or purchase invoices, and the Department had to obtain purchase information
18 from petitioner's vendors. In any event, petitioner has not provided evidence that supports increases in
19 the pilferage allowances. Regarding the analysis showing a decrease in purchases after Ms. Sandoval
20 was terminated (on December 20), we find that the decrease in merchandise purchases after
21 Ms. Sandoval's termination could simply have been the result of increased purchases in anticipation of
22 the holiday periods, with lower levels of purchases in January. Also, since petitioner's merchandise
23 purchases were not consistent from month to month, any analysis of fluctuations in purchase levels is
24 of limited evidentiary value. Thus, we find that petitioner has not documented thefts of merchandise in
25 amounts greater than those accounted for in the Department's calculations.

26 With respect to the alleged 5 percent merchandise returns (petitioner calls them "charge
27 backs"), we find that these were actually price discounts on certain types of merchandise that were
28 already taken into account in the audit. Thus, no adjustment is recommended for this argument.

1 Regarding petitioner's claim that audited food sales are excessive, we note that the average
2 daily amount of sales of \$45.22 is based on the Department's review of guest checks. That amount is
3 based on the best available information and appears reasonable. Further, petitioner has provided no
4 evidence to support a lower amount, and we find no adjustment is warranted.

5 We reject petitioner's assertion that bank deposits should be used to establish audited taxable
6 sales, since we find that a bank deposit analysis is not as reliable as the audit method used by the
7 Department. In a business such as petitioner's, a vast majority of customers pay in cash and there is
8 thus no way to insure that all cash was deposited. In fact, if petitioner's employees were stealing
9 substantial funds, as petitioner alleges, it is certain that petitioner did not deposit all taxable gross
10 receipts into his bank accounts.

11 **Issue 3:** Whether the Department has met its burden to prove fraud by clear and convincing
12 evidence.⁴ We conclude that the Department has done so.

13 The Department imposed the fraud penalty because it found that petitioner was a
14 knowledgeable taxpayer who intentionally understated the taxable sales reported to the Board.
15 Petitioner disputes the remaining fraud penalties because: 1) most, if not all, of the understatement was
16 due to employee theft; 2) there was no intent on his part to under-report his sales; and 3) he did not
17 have time to keep records.

18 The only records provided for audit were copies of bank statements and copies of the sales and
19 use tax returns, even though the Department issued a subpoena to petitioner for his books and records.
20 Although he had been audited previously and was aware of the record-keeping requirements, petitioner
21 did not provide cash register tapes, guest checks, sales journals, purchase journals, purchase invoices,
22 check registers, general ledgers, federal income tax returns, or worksheets that show how the sales and
23 use tax returns were prepared. Furthermore, petitioner is a CPA, and is thus knowledgeable in matters
24 of accounting. We expect that a CPA such as petitioner would have maintained at least a simple set of
25 _____

26 ⁴ Without regard to whether the finding of fraud is upheld, the NOD issued January 26, 2004, was timely issued for the
27 period October 1, 2000, through June 30, 2001, and the NOD issued December 29, 2005, was timely issued for the period
28 October 1, 2002, through December 31, 2003, under the 3-year statute of limitations (Rev. and Tax. Code § 6487, subd.
(a)). The NOD issued December 29, 2005, was timely issued for the period July 1, 2001, through September 30, 2002,
under the under the 10-year statute of limitations (Rev. and Tax. Code § 7073, subd. (d)).

1 books and records. We question how petitioner could expect to profitably operate a business without
2 maintaining any books and records, and we simply do not accept his assertion that he was too busy to
3 maintain books and records. We conclude that petitioner's failure to provide books and records for
4 audit was due to his desire to conceal his sales and purchases from the Department.

5 Also, the source of petitioner's reported amounts of taxable sales is not clear. Although
6 petitioner asserts that he used bank deposits to report his sales, bank deposits do not reconcile with
7 reported sales amounts. Since petitioner has not provided a satisfactory explanation for the amounts of
8 sales he reported on the sales and use tax returns, we conclude that petitioner falsified the sales and use
9 tax returns by reporting amounts he knew to be incorrect. Moreover, the amount of unreported taxable
10 bar sales and food sales combined of \$1,120,240 (\$1,067,343 + \$52,897) is substantial and represents
11 an error ratio of 198 percent when compared to reported taxable sales of \$566,447. Thus, petitioner
12 reported only about one-third of his taxable sales, and, as explained under Issue 2, we reject his
13 assertion that the understatement was the result of pilferage. We find that there is no plausible non-
14 fraudulent explanation of an understatement of that magnitude, particularly in light of the absence of
15 records and petitioner's inability to satisfactorily explain how the sales and use tax returns were
16 prepared. Thus, we conclude that the Department has met its burden to prove fraud by clear and
17 convincing evidence, and that the fraud penalty was properly applied.

18 **OTHER MATTERS**

19 The amnesty interest penalty under Revenue and Taxation Code section 7074, subdivision (a),
20 is not applicable in these cases because petitioner filed an application for amnesty and entered into a
21 qualifying installment payment plan.

22
23 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
24
25
26
27
28

Markup information

(For the period October 1, 2000, through December 31, 2003)

Audited ex-tax markups, based on a shelf test	Liquor 343.14% Domestic beer 263.66%, premium bottled beer 221.64%, 24-ounce beer 296.37%, draft beer 180.55%, large cans of Foster's beer 176.80%.
Liquor pour Self consumption Overpouring & spillage allowed Pilferage	1.86 oz, the average size of two drinks purchased in undercover pour test 3% 12% spillage allowed in computing markup 11.21% - 2001 4.30% - 2002 2.00% - 2003
Beer pour sizes Overpouring & spillage Self consumption Breakage Waste Pilferage	Draft beer - 12 ounces for mugs (75% of draft beer), 22 ounces for pilsner glasses (20% of draft beer), and 60 ounces for pitchers (5% of draft beer) 10% 3% 1% of purchases 5% allowed against purchases in addition to 10 % allowed in computing markup 4.48% - 2001 2.62% - 2002 2.00% - 2003
Self-consumption allowed in dollars	\$14,153
Pilferage and shrinkage allowed in dollars	\$8,019 – beer \$8,972 – liquor

The Department segregated beer purchases into categories of domestic beer, premium bottled beer, 24-ounce bottled beer, premium draft beer, and large cans of Foster's beer, based on purchase confirmations from beer suppliers.

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 WILLIAM G. MORSCHAUSER, dba) Account Number SR AP 17-811203
 6 Friar Tuck's Bar and Grille) Case ID 530753
 7 Petitioner) Pomona, Los Angeles County

8 Type of Business: Sports bar

9 Audit period: 01/01/04 – 06/30/09

10 Item Disputed Amount11 Unreported taxable sales \$1,244,741
12 Fraud penalty \$ 27,976TaxPenalty

13 As determined and proposed to be redetermined \$111,901.96 \$27,975.58

14 Less concurred - 8,743.68 00.00

15 Balance, protested \$103,158.28 \$27,975.58

16 Proposed tax redetermination \$111,901.96

17 Interest through 07/31/13 60,845.42

18 Fraud penalty 27,975.58

19 Total tax, interest, and penalty \$200,722.9620 Monthly interest beginning 08/01/13 \$ 559.51

21 This matter was scheduled for Board hearing in July 2012, but was postponed at petitioner's
 22 request to allow additional time to prepare. It was rescheduled for Board hearing in October 2012, but
 23 was postponed for settlement consideration.

24 **UNRESOLVED ISSUES**

25 **Issue 1:** Whether adjustments are warranted to the unreported taxable sales of alcoholic
 26 beverages. We find no adjustment is warranted.

27 Petitioner operated a sports bar that had been audited twice prior to this audit. Petitioner
 28 provided only an incomplete set of sales and use tax returns and an incomplete set of bank statements
 for the period July 2004 through December 2006. When the Sales and Use Tax Department
 (Department) requested that petitioner complete a Bar Fact Sheet, he declined to do so.

1 The Department decided to establish taxable sales of alcoholic beverages on a markup basis.
2 To establish purchases of beer and liquor, the Department used information obtained from the major
3 distributors in petitioner's area. The Department reduced audited purchases of beer and liquor by
4 2 percent for self-consumption and 2 percent for pilferage. It also estimated purchases of bottled beer,
5 using the percentage of bottled beer established in the most recent prior audit, and reduced that figure
6 by 1 percent for breakage. Since petitioner did not provide information regarding its merchandise
7 costs or selling prices, the Department used the markups that had been established in a shelf test for the
8 audit of the period January 1, 1997, through December 31, 1999 (which markups had also been used in
9 the audit of the period October 1, 2000, through December 31, 2003). The Department computed an
10 understatement of reported taxable sales of alcoholic beverages of \$1,085,747 for the period July 1,
11 2004, through June 30, 2009, which represented percentages of understatement of 121.83 percent for
12 the period July 1, 2004, through December 31, 2004, 83.69 percent for 2005, 77.22 percent for 2006,
13 67.61 percent for 2007, 55.95 percent for 2008, and 48.05 percent for January 1, 2009, through
14 June 30, 2009. To establish the understatement by quarter, the Department applied those percentages
15 of error to reported taxable sales, using 121.83 percent for the period January 1, 2004, through June 30,
16 2004, and it computed an understatement of \$1,244,741.

17 Petitioner contends that the audited taxable sales of alcoholic beverages are overstated because
18 the allowances for pilferage should be increased to 29 percent for draft beer, 15 percent for bottled
19 beer, 25 percent for liquor, and 20 percent for wine. Petitioner states that one of his bartenders stole
20 significant amounts, and then other bartenders also used the same theft scheme. According to
21 petitioner, the bartender(s) would serve several drinks to a customer, but would not ring the drinks on
22 the register. When the customer left the bar he or she would leave money on the bar and the
23 bartender(s) would put the entire amount in his or her tip jar. Petitioner argues that this procedure
24 represents a theft of merchandise. Specifically, petitioner asserts that the customers involved were
25 aware of the scheme, that the employee had possession of the merchandise at the time he or she gave
26 the drink to the customers, and that neither the employee nor the customer intended to consummate the
27 sale. Based on petitioner's description of his employees' theft, the theft of money occurred after the
28

1 sale of the merchandise, and the sales are subject to tax.¹ Further, we find that petitioner has not
2 shown that there were other thefts of merchandise or provided documentation adequate to support
3 increases to the adjustments for pilferage. Accordingly, we find no adjustment is warranted to the
4 unreported sales of alcoholic beverages.

5 **Issue 2:** Whether the Department has established fraud by clear and convincing evidence. We
6 find that the Department has.²

7 The Department imposed a fraud penalty because it found that petitioner willfully and
8 intentionally participated in an attempt to evade payment of the tax. Petitioner protests the penalty on
9 the basis that he believed he was reporting correctly and that he was not given proper advice from the
10 Department. Also, petitioner argues that the understatement would be minimal if adequate adjustments
11 were made for theft losses.

12 Petitioner has a thorough knowledge of the requirements of the Sales and Use Tax Law. He is
13 a CPA and an attorney, has operated the bar since January 1, 1990, and was audited twice before.
14 Nevertheless, petitioner substantially understated his reported taxable sales throughout the entire audit
15 period. Further, similar errors have been identified by the Department in each of the three audits, and
16 the percentages of understatement have been significant, at about 100 percent, 200 percent, and
17 80 percent, for the three audits (from oldest to most current). Thus, there is a clear, continued pattern
18 of substantial underreporting that cannot be attributed to mere negligence. Further, even though
19 petitioner had been audited previously and should have been well aware of the types of records
20 required, the records provided for audit were grossly inadequate. Petitioner provided no summary
21 schedules of purchases or sales, federal income tax returns, sales and use tax worksheets, or source
22 documents. Moreover, when the Department requested information regarding current selling prices,

23 _____
24 ¹ Petitioner also cites to Revenue and Taxation Code section 32211 to support his argument that these were not his sales,
25 contending that, since he has accounted for this liquor, it is not regarded as sold. We note that section 32211 does not
26 resolve petitioner's issue since, under his interpretation, liquor that can be accounted for as sold would not be regarded as
27 sold, which is an illogical result. That is, the question here is whether the transactions were sold by petitioner or not. In
28 any event, section 32211 is part of the Alcoholic Beverage Tax Law and is not relevant here, where petitioner is appealing a
Notice of Determination issued pursuant to the Sales and Use Tax Law.

² Without regard to whether the finding of fraud is upheld, the Notice of Determination was timely issued for the period
July 1, 2004, through December 31, 2006, under the 3-year statute of limitations, since petitioner had signed waivers
extending the period for issuing a determination. (Rev. and Tax. Code § 6487, subd. (a) and § 6488). Absent a finding of
fraud, the determination would not have been timely for the period January 1, 2004, through June 30, 2004.

1 petitioner declined to complete a Bar Fact Sheet. Petitioner's failure to provide adequate records is
2 also a repeated pattern, the Department having found it necessary to subpoena his records for the most
3 recent prior audit and, even then, the records provided were inadequate. We find that the continued
4 failure to provide adequate records by a knowledgeable business person who operated the bar for
5 almost 20 years, and the consistent pattern of substantial under-reporting throughout three audit
6 periods, are clear and convincing evidence of petitioner's intent to evade the tax. Accordingly, we find
7 the fraud penalty was properly imposed.

8 **OTHER MATTERS**

9 None.

10
11 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

1
2
3 **MARKUP TABLE**
4 **Taxable Sales of Alcoholic Beverages**
5

6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

Percentage of taxable vs. nontaxable purchases (all alcoholic beverages)	100%
Mark-up percentages developed in the audit of the period January 1, 1997, through December 31, 1999, used in this audit because petitioner provided neither current selling prices nor purchase invoices from which purchase costs could be established	249.14% for beer 343.14% for liquor
Self-consumption allowed in dollars	For 7/1/04-6/30/09: \$10,515 – beer \$ 3,943 - liquor
Self-consumption allowed as a percent of taxable purchases	2%
Pilferage allowed in dollars	For 7/1/04-6/30/09: \$10,304 – beer \$ 3,864 - liquor
Pilferage allowed as a percent of taxable purchases	2%