

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petitions for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 CHAOYUN LI and LAXIU TIAN, dba) Account Number SR JH 100-560716
 6 Peking Tokyo Restaurant & Sake Bar) Case ID's 546378, 436192
 7 Petitioner) Ukiah, Mendocino County

8 Type of Business: Restaurant

9 Audit periods: 04/01/07 – 03/31/10 (Case ID 546378)
 10 11/08/04 – 03/31/07 (Case ID 436192)

11 <u>Item</u>	<u>Disputed Amount</u>	
12 Unreported taxable sales	\$449,933(Case ID 546378)	
	\$553,495 (Case ID 436192)	
13 Negligence penalty	\$ 3,633 (Case ID 546378)	
	\$ 3,556 (Case ID 436192)	
		<u>546378</u>
14 Tax as determined and protested	\$36,327.64	<u>436192</u>
15 Interest through 07/31/14	13,943.91	\$41,822.55
16 Negligence penalty	<u>3,632.80</u>	27,464.09
17 Failure-to-file penalty		3,555.81
		<u>626.46</u>
18 Total tax, interest, and penalty	<u>\$53,904.35</u>	\$73,468.91
19 Payments		- 11.70 ¹
20 Balance Due		<u>\$73,457.21</u>
21 Monthly interest beginning 08/01/14	<u>\$ 181.64</u>	<u>\$ 209.05</u>

22 **BACKGROUND**

23 Petitioner began operating a restaurant in November 2004 and discontinued business on or after
 24 June 19, 2011.² The Sales and Use Tax Department (Department) has conducted audits of the business
 25 for the periods November 8, 2004, through March 31, 2007, (earlier period) and April 1, 2007, through
 26 March 31, 2010 (latter period). Petitioner filed timely petitions for redetermination with respect to

27 ¹ Petitioner has not filed a claim for refund of this payment, but the time for filing a timely claim for refund will not expire
 until six months after the date the determination becomes final. (See Rev. & Tax. Code, § 6902.)

28 ² Petitioner's seller's permit was closed effective June 19, 2011, although there are indications that petitioner may have
 continued to operate the business through August 2011. However, since the audit periods at issue here end before 2011, we
 need not address the possible inconsistency in the close-out date.

1 both Notices of Determination (NOD) (Case ID's 436192 for the earlier period and 546378 for the
2 latter period). For the earlier period, petitioner filed a settlement proposal, and it requested on
3 March 9, 2009, that the appeals conference regarding that appeal be postponed pending settlement
4 review. An appeals conference was held on February 2, 2012, regarding the petition for
5 redetermination for the latter period, and the earlier period was not addressed. A Decision and
6 Recommendation (D&R) was issued regarding the appeal for the latter period (Case ID 546378) on
7 July 16, 2012, recommending no adjustment to the amount of unreported taxable sales or the
8 negligence penalty, but recommending that Laxiu Tian not be held liable for amounts related to the
9 period January 1, 2009, through March 31, 2010.

10 At the time the Board hearing was originally scheduled (for May 2014) for the related account
11 (Jialing Wang; SR JH 97-228595; Case ID's 436517 and 546372), we noted that petitioner's appeals
12 should be considered at the same hearing as the appeals of the related account. We also noted that
13 petitioner's appeal for the earlier period was no longer under settlement consideration, but that no
14 D&R had been issued. In an April 9, 2014 letter, we explained to petitioner that the appeal for the
15 latter period was ready to be scheduled for hearing. We also noted that the issues in the appeal for the
16 earlier period seem nearly identical to the issues in the petition for redetermination of the latter period.
17 We stated that it appeared efficient to consolidate the appeals for the two periods and to apply the
18 analysis from the D&R to the appeal for the earlier period. We asked petitioner to let us know by
19 May 9, 2014, if it objected to proceeding to Board hearing regarding the appeal for the earlier period,
20 even though a D&R had not been issued for that period. Petitioner's manager, Jialing Wang, called on
21 or about April 23, 2014, and stated that petitioner agrees to consolidation of the two appeals and to
22 presenting the appeal for the earlier period to the Board without a D&R related to that period. Thus,
23 this summary addresses the appeals for both periods.

24 UNRESOLVED ISSUES

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

27 Petitioner provided virtually no records for the earlier audit period. It operated without a
28 seller's permit from November 8, 2004, through March 31, 2005, and reported sales were estimated

1 amounts for the earlier audit period. For the latter audit period, petitioner provided a sales journal and
2 bank statements. Using the sales journal, the Department computed that recorded credit card sales
3 represented about 79 percent of recorded total sales. The Department considered that percentage
4 higher than expected, particularly since it had computed ratios of credit card sales to total sales for the
5 earlier audit period of 22.5 percent and 28.3 percent. The Department regarded the high percentage of
6 recorded credit card sales as evidence that petitioner had not recorded all of its cash sales.

7 For both audit periods, the Department used a credit card analysis to establish audited taxable
8 sales. The Department used the results of a one-day observation test in each audit to compute
9 percentages of credit card sales to total sales of 35.72 percent for the latter period and 22.5 percent for
10 the earlier period. The Department used those percentages and the recorded credit card deposits to
11 compute audited taxable sales, which it compared to reported amounts to compute understatements of
12 \$397,592 for the latter period and \$642,325 for the earlier period. The Department completed revised
13 audits before the NOD's were issued. For the latter period, it corrected a computation error that
14 revised the ratio from 35.72 percent to 33.66 percent, which resulted in an increase of the
15 understatement to \$449,933. For the earlier period, the Department conducted a second observation
16 test, for which it computed a ratio of credit card sales of 28.3 percent. The Department combined the
17 results of the two observation tests to compute a ratio of credit card sales to total sales of 25.08 percent
18 for the earlier period, which it used to compute an understatement of taxable sales of \$553,495.

19 For both audit periods, petitioner contends that the audited sales are unrealistic. Petitioner
20 asserts that the restaurant could not have made the amounts of sales established in the audits because it
21 employed only one cook and one person waiting tables. Petitioner argues that one cook can generate
22 no more than \$10,000 a month in sales. Petitioner also argues that it is not reasonable to use the results
23 of a two-day observation test to establish audited sales for the earlier audit period, because sales had
24 increased significantly since Mr. Wang began managing the restaurant (after the audit period). For the
25 latter period, petitioner asserts that the one-day test is not representative because the economy had
26 declined 30 percent since its prior audit. On that basis, petitioner argues that the average audited sales
27 per quarter should have decreased in the latter audit period, instead of remaining approximately the
28 same (\$75,569 for the earlier audit period and \$75,636 for the latter audit period).

1 Petitioner has provided no evidence to support its contention that audited taxable sales are
2 unrealistic. For the earlier period, petitioner provided no summary records or documents of original
3 entry, and the amounts of sales reported on sales and use tax returns were estimated. Regarding
4 petitioner's assertion that the restaurant could not have made sales greater than \$10,000 per month, we
5 note that petitioner reported average monthly sales of \$12,714 for the latter audit period, which directly
6 contradicts its assertion. Moreover, the Department computed that audited sales for the earlier audit
7 period represented about 12 meals per hour, which we do not find unreasonable. Consequently, we
8 find the evidence does not show that audited sales are unrealistic.

9 Regarding petitioner's assertion that it was not reasonable to use the results of a one-day
10 observation test to establish audited sales, we note that audited sales were based primarily on
11 petitioner's recorded credit card deposits for each audit period. The Department used the results of the
12 observation tests (a one-day test for the latter period and a two-day test for the earlier period) only to
13 establish ratios of credit card sales to cash sales. Petitioner has provided no evidence that the
14 percentages of patrons paying with credit cards were significantly lower on the three observation days
15 than they were during the remainder of the audit periods. Moreover, for the earlier period, we find it
16 irrelevant that sales may have increased since Mr. Wang became the manager of the restaurant because
17 an increase in sales would not automatically relate to a decrease in the percentage of credit card sales
18 to total sales.

19 Regarding the latter period, petitioner has provided no evidence to support its assertion that its
20 sales decreased by 30 percent since the earlier audit period. In fact, petitioner's *reported* sales
21 increased from an average of \$26,130 per quarter in the earlier audit period to \$38,142 in the latter
22 audit period. Also, petitioner's average monthly credit card deposits increased from \$8,403 to \$10,439
23 to \$11,302 for the first, second, and third 12-month periods of the audit period, respectively. Thus,
24 petitioner's description of decreasing sales is inconsistent with the amounts it reported to the Board
25 and with its increasing credit card receipts. In any event, as explained previously, audited sales were
26 computed using recorded credit card deposits and an audited ratio of credit card sales to total sales, and
27 the variable in that audit procedure is the ratio of credit card sales to total sales. As noted previously,
28 the ratio computed for the latter audit period is 33.66 percent, which is materially higher than the ratio

1 computed for the earlier audit period of 25.08 percent. Petitioner had provided no evidence that there
2 was an even greater increase in its patrons' use of credit cards during the latter audit period.

3 We find that the Department used a recognized audit procedure to establish audited taxable
4 sales, and we have found no apparent errors in either audit. Petitioner has provided no evidence to
5 support adjustments, and we recommend none.

6 **Issue 2:** Whether petitioner was negligent. We find that the understatements established for
7 both audit periods were the result of negligence.

8 The Department imposed negligence penalties because petitioner's records were inadequate.
9 For the earlier audit period, taxpayer provided no records, operated without a seller's permit from
10 November 8, 2004, through March 31, 2005, reported zero sales on the return for the second quarter
11 2005, and then reported estimated amounts of sales for the remainder of the audit period. For the latter
12 audit period, although petitioner provided some (limited) records, the Department found that petitioner
13 continued to understate the amount of cash sales reported, as it had in the earlier audit period.
14 Petitioner did not specifically dispute the negligence penalty for the earlier audit period and, for the
15 latter audit period, it asserts that no penalty is applicable because reported sales are correct.

16 Since we have previously concluded that no further adjustments are warranted to the audited
17 amounts of unreported taxable sales, we reject petitioner's claim that reported sales are correct. For
18 the earlier period, we find that the absence of records, the failure to obtain a seller's permit, the
19 estimated reported amounts, and the substantial deficiency are clear evidence of negligence. Further,
20 we find that any business person, even one with limited experience, should know that the amounts of
21 sales reported on sales and use tax returns are expected to be accurate, rather than estimates. Thus, we
22 find that the negligence penalty was properly applied to the NOD for the earlier audit period, even
23 though petitioner had not been audited previously. For the latter audit period, we find that the limited
24 records and the repeated failure to report all cash sales are strong evidence of negligence.

25 **Issue 3:** Whether both Chaoyun Li and Laxiu Tian are liable as partners for the audit liabilities.
26 We conclude that both are liable for the amount determined for the earlier audit period, and, for the
27 latter period, through December 31, 2008; Chaoyun Li is solely liable for the period January 1, 2009,
28 through March 31, 2010.

1 In a written statement submitted January 3, 2012, Chaoyun Li asserts that partner Laxiu Tian
2 ceased acting as an owner of the business in 2006. At the appeals conference, Ms. Li and her son,
3 Jialing Wang, claimed that Ms. Li operated the business as a sole proprietor following Ms. Tian's
4 departure in 2006. After the conference, Mr. Wang provided a copy of a Fictitious Business Name
5 Statement filed with the Mendocino County Clerk, recorded on February 25, 2008, which indicates
6 that Ms. Li began operating the restaurant as an individual on that date. The Department concludes,
7 and we concur, that the ownership of the business changed from a partnership to a sole proprietorship
8 on February 25, 2008. However, petitioner did not notify the Board of the change in ownership.

9 Petitioner has provided no evidence of a change in business ownership prior to February 25,
10 2008, and we find that the business was operated by petitioner until that date. However, petitioner did
11 not notify the Board that the business had been transferred from petitioner to a sole proprietorship.
12 Also, petitioner had actual knowledge that the sole proprietorship of Chaoyun Li thereafter operated
13 under petitioner's seller's permit. Accordingly, we find that petitioner (the partnership of Chaoyun Li
14 and Laxiu Tian) is liable as a predecessor for the tax, interest, and penalties incurred by Chaoyun Li as
15 a sole proprietor after the business was transferred on February 25, 2008. However, since petitioner
16 did not hold 80 percent or more of the real or ultimate ownership of the business after the transfer,
17 petitioner's predecessor liability is limited to the first quarter of 2008, the quarter during which the
18 business was transferred, and the three subsequent quarters (the remainder of 2008). (Rev. & Tax.
19 Code, § 6071.1; Cal. Code Regs., tit. 18, § 1699, subd. (f).) Consequently, we find that both Chaoyun
20 Li and Laxiu Tian are liable for the tax, interest, and penalties incurred by the business for the period
21 April 1, 2007, through December 31, 2008, but Chaoyun Li is solely liable for amounts incurred for
22 the remainder of the audit period (January 1, 2009, through March 31, 2010).

23 OTHER MATTERS

24 Since petitioner did not file returns for the period November 8, 2004, through March 31, 2005,
25 a failure-to-file penalty has been imposed with respect to audited sales for that period. Petitioner has
26 not filed a request for relief of the failure-to-file penalty, and we are aware of no circumstances that
27 could represent reasonable cause for its failure to obtain a seller's permit and file returns.

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