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: WING SANG, INC., dba New Capital Seafood Restaurant Petitioner	Account Number SR AP 101-176030 Case ID 614232 City of Industry, Los Angeles County

Type of Business: Restaurant

Audit period: 01/01/09 – 09/30/11

Item	Disputed Amount
Unreported taxable sales	$675,397

	Tax	Penalty
As determined	$71,177.73	$7,117.80
Post-D&R adjustment	00.00	- 7,117.80
Proposed redetermination	$71,177.73	$ 00.00
Less concurred	- 6,263.91	
Balance, protested	$64,913.82	
Proposed tax redetermination	$71,177.73	
Interest through 08/31/15	23,901.28	
Total tax and interest	$95,079.01	
Monthly interest beginning 09/01/15	$ 355.89	

UNRESOLVED ISSUE

Issue: Whether adjustments are warranted to the amount of unreported taxable sales. We find no adjustment is warranted.

Since December 2008, petitioner has operated a restaurant with three separate rooms for small parties and banquets and a total seating capacity of approximately 388 people. For audit, petitioner provided financial statements, general ledgers, bank statements, credit card merchant statements, purchase invoices, sales reports with cash register z-tapes and detailed cash register tapes for some months, and federal income tax returns (FITR's).

The Sales and Use Tax Department (Department) found that total sales reported for sales and use tax purposes substantially reconciled with gross receipts reported on FITR's. The Department computed book markups of 118 percent for fiscal year ending (FYE) September 30, 2009, and 96 percent for FYE 2010, which were lower than the markup of over 200 percent that the Department expected. Also, the Department made a purchase at the business on January 9, 2011, paying with cash. When it examined the sales detail for the cash register for that day, it was unable to locate that sale.[1] Based on these observations, the Department concluded that reported taxable sales were likely understated.

The Department decided to use a credit card sales to total sales ratio to establish audited sales, and it observed petitioner's business for two days, a Saturday and a Tuesday. For those days, the Department computed that credit card sales represented 74.9 percent of total sales, including sales tax reimbursement and that 8.66 percent of the amounts charged on credit cards represented optional tips. Subsequently, petitioner provided credit card data for the third quarter of 2009 (3Q09), 3Q10, and 3Q11, and the Department computed that 10.2 percent of the amounts charged on credit cards represented optional tips.

The Department reduced the total credit card deposits by optional tips, computed at 10.2 percent, and it divided the remainder by 74.9 percent to compute audited taxable sales, including tax. The Department reduced the audited taxable sales by the amount of sales tax included, on a quarter-by-quarter basis. Since petitioner's reported taxable sales for 3Q11 exceeded the audited amount for that quarter, the Department concluded that reported taxable sales for that quarter were correct. For the remainder of the audit period, the Department computed audited taxable sales of $11,209,849, which exceeded reported taxable sales of $10,534,453 by $675,397 (rounded).

Petitioner contends that audited taxable sales are excessive, asserting that the 74.9 percent credit card sales to total sales ratio is not representative of the entire audit period. Petitioner states that its credit card sales ratio was higher in earlier periods. Also, petitioner argues that the small error rate is evidence that reported amounts are accurate. Further, petitioner states that its business is similar to the predecessor's business and argues that, if the Department used the 80.86 percent credit card sales to total sales ratio observed for the predecessor, the result would be a no-change audit.

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[1] Petitioner stated that the absence of the sale on the cash register tape likely was the result of employee thefts.

We note that the Department used a two-day observation test to compute the audited ratio of credit card sales to total sales of 74.9 percent. Although it computed a percentage of tips included in the credit card sales for those two days of 8.66 percent, it increased that percentage to 10.2 percent based on additional credit card sales data provided by petitioner for three quarters. We find that the Department's audit procedures were appropriate, and we find that a two-day test generally is sufficiently long to be representative.

Regarding petitioner's assertion that the operation of the business was similar to the predecessor's and its argument that the 80.86 percent credit card sales to total sales ratio computed for the predecessor should be used in this audit, we note that this assertion is contradicted by statements in the petition for redetermination. The petition states that, when the ownership of the business changed, there was a complete change in management and that most of the employees changed. It also states that there was a change in the business environment, management style, business practice, and clientele. Consequently, we reject petitioner's assertion that the business operations remained unchanged and that the Department should use the 80.86 percent credit card sales to total sales ratio observed for the predecessor. Petitioner has provided no documentary evidence to support a higher credit card sales to total sales ratio. With respect to its assertion that the ratio was higher in earlier portions of the audit period, we note there is evidence that petitioner at one time had a policy of not accepting credit cards for sales less than $30. It is probable that such a policy would result in a lower, rather than higher, credit card sales to total sales ratio. Accordingly, we find there is no basis for using a higher credit card sales to total sales ratio for any portion of the audit period. Moreover, we note that the Department accepted reported total sales for 3Q11 as substantially accurate. For that quarter, the credit card sales to total sales ratio is 70.92 percent, which is lower than the 74.9 percent used in the audit calculations. Thus, the accuracy of reported sales for 3Q11 offers additional evidence that there is no basis for increasing the percentage used to compute sales for the remaining quarters of the audit period.

We also reject petitioner's assertion that the low error rate of 5.69 percent is evidence that total sales were accurately reported. We find that the computed understatement of $675,397 is significant, and the low error ratio is not evidence that reported sales were accurate.

In addition, we compared audited taxable sales of $4,736,276 for the fiscal year ending September 30, 2010, with the cost of goods sold reported on the FITR for that fiscal year of $2,226,453 to compute a markup of 112.7 percent. Since that markup is lower than the markup we would normally expect for this type of restaurant (over 200 percent), we find that the audited sales are reasonable, if not conservative. In short, we find there is no basis for adjustment.

RESOLVED ISSUE

The Department applied a negligence penalty because the records provided for audit were inadequate, and the understatement was significant. Petitioner disputes the penalty on the basis that any understatement was the result of employee theft rather than negligence.

We agree with the Department that the records were inadequate, and the amount of understatement of $740,570, including the concurred amount of purchases subject to use tax of $65,173, is significant. However, we find that the understatement of reported taxable sales of $675,397 represents an error ratio of 5.69 percent when compared with reported taxable sales of $11,862,657. While the error ratio is significant, we find that the percentage of understatement is not sufficiently large to establish negligence, particularly since petitioner had not been audited previously. Accordingly, we recommend that the negligence penalty be deleted.

OTHER MATTERS

None.

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