

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
) Account Number: SC CH 99-222213
 5 COMMODORE CRUISES & EVENTS, INC.,) Case ID 424031, 514975
 fka Commodore Dining Cruises, Inc.)
 6 Petitioner)
 7) Alameda, Alameda County

8 Type of Business: Dining cruises
 9 Audit Period: 01/01/04 – 12/31/06

<u>Item</u>	<u>Amount</u>	<u>Tax</u>	<u>Penalties</u>
11 Understated taxable sales	\$1,872,337		
12 Negligence penalty	\$16,245		
12 Claim for refund	\$225,456		
14 As determined and protested:	<u>\$162,450.21</u>	<u>\$16,245.04</u>	
15 Proposed tax redetermination	\$162,450.21		
16 Interest through 10/31/08 (tax paid in full 10/30/08)	48,814.36		
16 Negligence penalty	<u>16,245.04</u>		
17 Total tax, interest, and penalty	\$227,509.61		
17 Payments	<u>-227,509.61</u>		
18 Balance due	<u>\$0.00</u>		

19 This matter was previously scheduled for Board hearing on April 13, 2010, and on May 25,
 20 2010, but both were postponed due to scheduling conflicts with petitioner's representative.

21 **UNRESOLVED ISSUES**

22 **Issue 1:** Whether adjustments are warranted to the audited amount of unreported mandatory
 23 gratuity charges and food and beverage sales. We recommend no adjustment.

24 Petitioner offers yacht cruises within the San Francisco Bay for private events such as
 25 weddings, holiday parties, and school proms, as well as cruises open to the public for Valentine's Day,
 26 Fourth of July, and New Year's Eve. During most of its cruises during the audit period, petitioner
 27 provided meals prepared by its employees, approximately 98 percent of which were buffets. Petitioner
 28 also made separate sales of liquor, soft drinks, and juices during some of its cruises (no-host bar).

1 Typically, petitioner charged a lump-sum price for its cruises. During the audit, the Sales and
2 Use Tax Department (Department) found that petitioner calculated its taxable sales of food, beverages,
3 and mandatory gratuities using various methods. One of petitioner's calculation methods involved
4 taking the total revenue generated during a particular cruise, subtracting the amount attributable to its
5 hourly yacht rental,¹ and reporting the difference as taxable sales of food and beverages. When this
6 method was used, petitioner sometimes also added an 18-percent gratuity charge to its computed
7 taxable sales of food and beverages. In addition, when a no-host bar was provided on the cruise,
8 petitioner calculated its reported beverage sales separately. Another calculation method involved
9 multiplying the number of persons aboard by a rate ranging from \$5 to \$15. When this method was
10 used, petitioner did not usually add an 18-percent gratuity charge to its computed taxable sales. Based
11 on these calculation methods, petitioner reported total taxable sales during the audit period of
12 \$1,529,563.

13 The Department established taxable sales by examining all of petitioner's contracts for the
14 months of February, March, April, and December 2006. From these contracts, the Department totaled
15 the gross amount of sales and subtracted the nontaxable charges for the cruise (i.e., charges attributable
16 to yacht rental, port fees, optional tips, flowers/décor, the casino, DJ/karaoke, security, damage
17 deposits, and fuel surcharges) to compute an amount representing petitioner's charges for food,
18 beverages, mandatory gratuity, and tax reimbursement. The Department reduced that amount for sales
19 tax included, computed at 8.75 percent, to establish the net amount of petitioner's charges for food,
20 beverages, and mandatory gratuity.

21 As long as the Department's calculations resulted in a charge of at least \$10 per person for
22 food, beverages, mandatory gratuity, and tax reimbursement, the Department accepted the amount it
23 calculated. Where the average amount it calculated was less than \$10 per person, the Department used
24 a figure of \$15 per person. The Department then added petitioner's bar charges for its separate sales of
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26 ¹ Although petitioner regarded its lump sum charge as including a component it characterizes as a yacht "rental" charge,
27 petitioner was not renting the yachts (it did not transfer control of the vessel to a lessee) and did not actually make a charge
28 for yacht rental, such a charge being simply one for charter of the vessel. Nevertheless, we use here the same terminology
as used in the D&R, which is based on petitioner's own terminology.

1 liquor, soft drinks, and juices to establish petitioner's total charges for food, beverages, gratuity, and
2 tax reimbursement for these cruises. The Department compared petitioner's reported taxable sales for
3 the four-month test period (\$143,360) to the audited taxable sales for the same period (\$318,854),
4 resulting in an understatement of \$175,494, which represents an error rate of 122.41 percent. The
5 Department projected the error rate to reported taxable sales for the audit period of \$1,529,563 to
6 establish unreported taxable sales of \$1,872,337.

7 Petitioner contends the amount of unreported taxable sales is overstated. Petitioner argues that
8 the tax it owes should be based only on its 15 percent service charges, and that the sales tax
9 reimbursement (8.75 percent) and port fees (1.25 percent) petitioner charged should have been
10 deducted from the audited taxable measure. According to petitioner, because its goal was to increase
11 its sales volume, not maximize the amount of profit per cruise, it charged lower rates for food,
12 beverages, and many other items in order to attract more customers. However, petitioner has not
13 provided any additional records to show that the Department's computations are not correct, nor has
14 petitioner disputed the Department's audit method, which is the one of the methods petitioner used to
15 calculate and report its taxable sales. Further, petitioner agreed that the four months utilized by the
16 Department as the test period (February, March, April, and December 2006) are representative of
17 petitioner's sales during the audit period.

18 Petitioner's argument that the Department improperly included sales tax reimbursement and
19 port fees in the unreported taxable measure is misplaced. The audit workpapers show that these
20 nontaxable amounts were backed out to establish taxable sales. We conclude that the Department's
21 audit method was valid and petitioner has provided no basis for adjustment.

22 **Issue 2.** Whether petitioner was negligent. We conclude that it was.

23 The Department applied the negligence penalty because it concluded that the reporting errors
24 noted in petitioner's prior audits had not been corrected and continued to occur in the current audit
25 period. The Department notes that both the third and fourth audits resulted in an assessment of
26 additional tax based on petitioner's underreporting of its mandatory gratuity charges and food and
27 beverage sales, as in the current audit. The Department also asserts that petitioner was specifically
28 informed in the April 14, 2004 Report of Audit for its fourth audit that it needed to improve its

1 reporting accuracy and that its failure to do so for the current audit period might be construed as
2 evasive in nature. In addition, the Department notes that it assessed a 10-percent negligence penalty in
3 the fourth audit because it determined that petitioner failed to maintain sufficiently accurate and
4 detailed records for sales and use tax purposes, and that failure has not been corrected in this audit
5 period. The Department further contends that the size of petitioner's understatement in this present
6 audit is evidence of negligence.

7 Petitioner disputes the penalty on the basis that, over the course of the last 20 years during
8 which it has operated its business (first as a partnership and then as a corporation), it has utilized the
9 same methods to calculate and report its taxable sales of food, beverages, and mandatory gratuity
10 charges, and that these calculation and reporting methods have been approved by the Department.
11 Petitioner also asserts that it relied on the Department's oral advice to use the same calculation and
12 reporting method it has always used. In addition, petitioner contends the fact that the Department did
13 not impose a penalty in the third audit further confirmed petitioner's belief that it was properly
14 calculating and reporting its taxable sales. Petitioner argues that since it used the same calculation and
15 reporting method during the current audit period as it did during the third audit period (April 1, 1994,
16 through March 31, 1997), the application of a negligence penalty is not appropriate here. To further
17 support its position, petitioner states the Department informed petitioner, during the course of the
18 current audit, that there are at least six different ways to calculate taxable sales for a business of this
19 nature, and that petitioner's choice to use one of those ways does not constitute negligence.

20 Each of the four prior audits of petitioner resulted in a deficiency. Although petitioner was
21 specifically informed of the need to correct its reporting errors in the April 14, 2004 Report of Audit, it
22 continued to make the same types of errors in the current audit period. Furthermore, in the current
23 audit, the Department established unreported taxable sales of \$1,872,337, resulting in a reporting error
24 rate of 122.41 percent. We find that petitioner's failure to correct its reporting errors, the size of the
25 understatement, and the percentage of error in excess of 100 percent are each strong evidence of
26 negligence. Accordingly, we find that petitioner failed to act with due care, that the understatement
27 was the result of negligence. Accordingly, we recommend that the negligence penalty be affirmed.

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OTHER DEVELOPMENTS

Petitioner has filed a claim for refund (Case ID 514975) asserting that the liability here was established by a faulty audit. Petitioner has not submitted any additional arguments with the claim for refund and we have already addressed petitioner’s arguments as to why no adjustments are warranted to the established liability. Accordingly, we recommend that the claim for refund be denied.

Summary prepared by Rey Obligacion, Retired Annuitant