

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:)
 5 MAIN STREET CALIFORNIA, INC.) Account Number: SR Y OH 99-412704
 6) Case ID 224746
 7 Petitioner) Phoenix, Arizona

8 Type of Business: Chain of T.G.I. Friday's restaurants

9 Audit period: 4/1/98 – 6/30/01

10 <u>Item</u>	<u>Measure</u>
11 Unreported mandatory gratuities	\$4,084,487
12 Amnesty interest penalty	\$ 79,993
	<u>Tax</u>
13 As determined	\$726,112.52
14 Adjustment: Appeals Division	<u>-391,986.68</u>
15 Proposed redetermination	\$334,125.84
16 Amount concurred in	<u>- 13,325.96</u>
17 Protested	<u>\$320,799.88</u>
18 Proposed tax redetermination	\$334,125.84
19 Interest through 8/31/10	315,941.89
20 Amnesty interest penalty	<u>79,993.42</u>
21 Total tax and interest	\$730,061.15
Payments	<u>- 23,299.34</u>
Balance due	<u>\$706,761.81</u>
Monthly interest beginning 9/1/10	<u>\$1,813.15</u>

22 The Board heard this matter on June 9, 2009, and upheld petitioner's liability with the
 23 adjustments we recommended. Petitioner filed a timely petition for rehearing. At its meeting on
 24 December 15, 2009, the Board granted petitioner's request for a rehearing. The matter was scheduled
 25 for rehearing by the Board on April 13, 2010, but was postponed because petitioner was not available
 26 to attend the hearing until July. It was then scheduled for rehearing by the Board on July 14, 2010, but
 27 was postponed because petitioner's representative had a family emergency.

UNRESOLVED ISSUES

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2 **Issue 1:** Whether the gratuities petitioner charged and collected for parties of eight or more
3 (large parties) were voluntary and therefore not subject to sales tax. We conclude that the gratuities at
4 issue were mandatory and thus subject to sales tax.

5 During the audit, the Sales and Use Tax Department (Department) found that petitioner's menu
6 included a statement that a gratuity of 15 percent would be added for parties of eight or more and that
7 the customer could increase or decrease the amount of the gratuity. The Department concluded that
8 these gratuities were mandatory and thus subject to tax. Petitioner did not collect sales tax
9 reimbursement on such gratuities.

10 Petitioner contends that the subject gratuities were not taxable because they were not
11 mandatory, and that all such amounts were distributed to its employees. Petitioner states that it would
12 ask a large party whether the gratuity should be added and that the manager had to authorize the
13 addition of the gratuity. Petitioner further states that the customers could increase or decrease the
14 amount of the gratuity, or decline to pay the amount of gratuity reflected on the check.

15 In 2004, when we issued the Decision and Recommendation in this matter, California Code of
16 Regulations, title 18, section (Regulation) 1603, subdivision (g), second paragraph, provided:

17 "Amounts designated as service charges, added to the price of meals are a part
18 of the selling price of the meals and, accordingly, must be included in the retailer's gross
19 receipts subject to tax even though such service charges are made in lieu of tips and are
20 paid over by the retailer to employees."

21 Under this provision, a service charge added by the retailer to the price of meals and beverages
22 was taxable, even if the charge was in lieu of a tip. This result is not changed by a statement on the bill
23 advising the customer that the charge may be raised, lowered, or eliminated. Here, petitioner's menu
24 included a statement that a gratuity of 15 percent would be added to the guest check for parties of eight
25 or more. Even though the menu also included a statement indicating that the customer may increase or
26 decrease the amount of the gratuity, the imposition of the gratuity was nevertheless mandatory, and
27 even as explained by petitioner, a customer seeking to avoid having to pay the gratuity had to take
28 affirmative action to avoid its application. We conclude that this was a mandatory gratuity that is
subject to sales tax.

1 In 2007, the Board amended subdivision (g) of Regulation 1603 to clarify when a gratuity will
2 be regarded as a taxable mandatory gratuity. As amended, Regulation 1603 makes it even more clear
3 that the gratuities here were mandatory. Subdivision (g)(2)(A) provides that a gratuity negotiated in
4 advance of the meal is mandatory. Here, the amount was clearly negotiated in advance since the menu
5 advised customers that the gratuity would be added for large parties. Where the menu notifies
6 customers that a gratuity will or may be added, an amount automatically added as a gratuity is
7 mandatory and subject to tax. (Cal. Code Regs., tit. 18, § 1603, subd. (g)(2)(B) (even if the gratuity is
8 indicated as “suggested” or “voluntary”).) Subdivision (g)(2)(C) states:

9 It is presumed that an amount added as a tip by the retailer to the bill or invoice
10 presented to the customer is mandatory. A statement on the bill or invoice that the
11 amount added by the retailer is a ‘suggested tip,’ ‘optional gratuity,’ or that ‘the amount
12 may be increased, decreased, or removed’ by the customer does not change the
13 mandatory nature of the charge.”

14 This presumption may be controverted by documentary evidence showing that the
15 customer specifically requested and authorized the gratuity be added to the amount
16 billed.

17 Examples of documentary evidence that may be used to overcome the presumption
18 include:

- 19 1. A guest check that is presented to the customer showing sales tax
20 reimbursement and the amount upon which it was computed, without tip
21 or with the “tip” area blank and a separate document, such as a credit
22 card receipt, to which the retailer adds or prints the requested tip.
- 23 2. Guest receipts and payments showing that the percentage of tips paid
24 by large groups varies from the percentage stated on the menu, brochure,
25 advertisement or other printed materials.
- 26 3. A retailer’s written policy stating that its employees shall receive
27 confirmation from a customer before adding a tip together with
28 additional verifiable evidence that the policy has been enforced. The
policy is not in itself sufficient documentation to establish that the
customer requested and authorized that a gratuity be added to the amount
billed without such additional verifiable evidence.

The retailer must retain the guest checks and any additional separate documents to show
that the payment is optional. The retailer is also required to maintain other records in
accordance with the requirements of Regulation 1698, *Records*.

The available evidence indicates that petitioner cannot overcome the presumption of

1 subdivision (g)(2)(C) that the subject gratuities were mandatory. We therefore conclude that the
2 gratuities were subject to tax.

3 **Issue 2:** Whether additional adjustments are warranted for the audited unreported taxable
4 gratuities. We conclude that no further adjustments are warranted.

5 During the audit, the Department noted that petitioner's daily sales reports have a separate line
6 item titled "Auto Gratuity" or "15% Gratuity." The Department found that petitioner netted such
7 gratuities from reported gross receipts. However, the total of such gratuities was not readily available
8 and petitioner indicated that it would be time-consuming to compile. The Department further explains
9 that, at the time the audit was conducted, petitioner did not want to spend resources to compile such
10 recorded amounts because petitioner believes the gratuities at issue were voluntary.

11 Since the actual recorded amounts of such gratuities were not available, the Department
12 decided to compute an average daily amount of mandatory gratuities per location. Based on a cursory
13 review of approximately 100 daily sales reports for two locations, store #1718 (Fresno) and store
14 #1918 (San Bruno), the Department found that the daily mandatory gratuities ranged from \$30 to \$400
15 per location, representing a mean amount of \$215 ($[\$30 \text{ low} + \$400 \text{ high}] \div 2$) per day per location.
16 The \$215 mean amount was applied to the total number of days a location was open during the audit
17 period (42,300 total business days) to establish audited mandatory gratuities of \$9,094,500 ($\$215 \times$
18 $42,300$) for the audit period.

19 Petitioner asked for reconsideration, indicating that it would provide documentation that would
20 support its contention that the audited taxable gratuities were excessive. In our Supplemental Decision
21 and Recommendation, we recommended that the Department conduct a reaudit, during which the
22 Department reviewed the documents provided by petitioner and established that the average daily
23 mandatory gratuities were \$96.53. Multiplying that average by the number of total business days that
24 petitioner's locations were open during the audit period, the Department established audited mandatory
25 gratuities of \$4,084,487. We concur with the reaudit results and conclude that no further adjustments
26 are warranted.

27 AMNESTY

28 An amnesty interest penalty of \$79,993.42 will apply under Revenue and Taxation Code

1 section 7074, subdivision (a), when the liability becomes final because petitioner did not apply for
2 amnesty. By letter to petitioner dated April 17, 2009, we explained the application of the amnesty
3 interest penalty and petitioner's right to ask for relief pursuant to Revenue and Taxation Code section
4 6592. With that letter, we also provided petitioner a form it could use to request relief from the
5 amnesty interest penalty. Petitioner has not returned the form or otherwise submitted a request for
6 relief of the amnesty interest penalty, and we therefore have no basis to consider recommending relief
7 of the penalty.

8 **PETITION FOR REHEARING**

9 In its petition for rehearing, petitioner contends: 1) there was no evidence supporting the
10 Board's conclusion that the subject gratuities were mandatory, and petitioner has now identified new
11 evidence showing that the subject gratuities were not negotiated in advance of the meal service and
12 that a number of petitioner's customers left gratuities less than the 15-percent gratuity suggested on
13 petitioner's menu (petitioner stated in a telephone conversation that the new evidence is in the form of
14 witness testimony); 2) even if the subject gratuities were mandatory, they would still not be subject to
15 sales tax because the tips were retained by petitioner's employees, were never in possession of
16 petitioner, and were not considered part of the compensation petitioner paid those employees for their
17 services; and 3) the Board's decision is contrary to law because it requires taxpayers like petitioner to
18 comply retroactively with a document retention policy established six to nine years after the audit
19 period at issue.

20 The issue of evidence supporting the finding that the gratuities were mandatory is fully
21 addressed above under issue 1. Petitioner's second contention in the petition for rehearing is without
22 merit. The issue is not how the funds were distributed, but rather whether the purchasers had to pay
23 such amounts in order to make the taxable purchases from petitioner. That is why the regulation,
24 applying the basic rule that a mandatory charge related to the taxable sale of tangible personal property
25 is taxable, explicitly states that mandatory gratuities are taxable. (Cal. Code Regs., tit. 18, § 1603,
26 subd. (g).) Accordingly, we reject petitioner's argument that mandatory gratuities are not taxable if
27 they are retained by its employees. Regarding petitioner's contention that the Board's decision
28 requires taxpayers like petitioner to comply retroactively with a document retention policy established

1 six to nine years after the period at issue, we note that Regulation 1698 has long required the retention
2 of records necessary to establish the proper sales and use tax liability. Accordingly, we find this
3 argument unpersuasive. For all these reasons, we find nothing in the petition for rehearing that
4 warrants a revision to our previous recommendation, and we thus continue to recommend that, other
5 than the adjustments discussed above, the petition be denied.

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