CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION SUMMARY FOR BOARD HEARING

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	
RONG GIN, INC., dba Fat Wok Restaurant	Account Number: SR GH 100-022208 Case ID 448665
Petitioner	San Jose, Santa Clara County

Type of Business: Restaurant

Audit period: 01/01/04 – 12/31/06

Item	Disputed Amount
Unreported sales	$142,006
Negligence penalty	$ 1,172

	Tax	Penalty
As determined:	$25,464.80	$2,546.46
Adjustment - Appeals Division	- 13,749.25	- 1,374.85
Proposed redetermination, protested	$11,715.55	$1,171.61

Proposed tax redetermination	$11,715.55
Interest through 11/30/10	5,374.37
Negligence penalty	1,171.61
Total tax, interest, and penalty	$18,261.53
Payments	- 3,187.90
Balance Due	$15,073.63
Monthly interest beginning 12/1/10	$ 48.17

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the amount of unreported sales. We recommend no further adjustment.

From March 1, 1985, through March 31, 2002, the business was operated by petitioner's corporate officers as a husband and wife partnership, and since April 1, 2002, petitioner corporation has operated this restaurant. Sales were rung up on a cash register and the cash register totals were posted to a single-entry sales journal, which was used by the outside bookkeeper to establish reported amounts.

The Sales and Use Tax Department (Department) found that the amounts of gross receipts reported on federal income tax returns for the three years of the audit period were reasonably consistent. However, the amounts of reported purchases, as well as the book markups computed using reported gross receipts and reported purchases, varied significantly from year to year. Also, the Department found that the amounts of claimed salaries and wages appeared low, based on the number of employees needed to operate the business. As a result, the Department decided to establish petitioner's taxable sales based on a flat projection of the audited weighted average monthly taxable sales established by a two-day observation test (Thursday, May 17, 2007, and Saturday, June 9, 2007), adjusted for a credit card growth rate factor. Petitioner contended that the audited amount of unreported sales was overstated because: 1) the observation tests were conducted on the two busiest days of the quarter; 2) petitioner increased the selling prices for most menu items in December 2006; 3) sales were lower in 2004 and 2005 as a result of a the dot.com bubble bursting, and sales began to improve in 2006; and 4) in the Department's review of petitioner's two bank accounts, some sales deposits were counted twice.

As explained in the D&R, we found that the audit had overstated taxable sales, but we also found that the audited percentage of credit card sales to total sales of 52.74 percent for the days of the observation test was representative of petitioner's business. Accordingly, we concluded that applying that ratio to the known credit card receipts would result in a fairly accurate amount of taxable sales. Based on this method, we recommended a reduction to the measure of deficiency from $308,663 to $142,006. Since this recommendation wholly avoids each of petitioner's bases for disagreeing with the Department's original audit method,[1] and since our recommendation reduced the deficiency by more than one-half, we contacted petitioner's representative, Mr. John Liu, by telephone on September 28, 2010, to inquire whether petitioner still disputes the remaining deficiency. Mr. Lui confirmed that

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[1] Applying the ratio of credit card sales to total sales developed from the two-day observation test to the amount of credit card receipts is not based on the volume of business on either day. Applying that ratio to the known credit card receipts takes into account petitioner's second and third arguments noted above because the credit card receipts reflect the actual selling prices for the applicable periods as well as any decrease of business because of the dot.com bubble bursting, or for any other reason (or any increase for any reason as well). Similarly, with respect to petitioner's final basis for disputing the original audit method, we did not use bank deposits in making our recommendation, and thus any duplication between the two bank accounts (such as those related to transfers between accounts) cannot affect our recommended adjustment.

petitioner continues to dispute the remaining deficiency because it is too high. Petitioner has not, however, provided any documentation to support a greater reduction, and we recommend no further adjustment.

Issue 2: Whether petitioner was negligent. We conclude it was.

The Department imposed the 10-percent negligence penalty because petitioner's records were incomplete and inadequate. Specifically, the sales journals were inaccurate, and the purchase invoices and guest checks appeared incomplete. Also, the understatement established by audit was over 50 percent. Petitioner disputes the penalty on the basis that there was no intent to under-report, and it asserts that all sales receipts have been reported.

Our recommended adjustment has reduced the percentage of understatement to 24.11 percent of the reported taxable sales of $588,976. We find that error ratio is significant, particularly since petitioner's corporate officers have operated this business for over 20 years. We find that a reasonably prudent businessperson with extensive experience in the restaurant industry would have established procedures to ensure that all cash sales were recorded and reported accurately, and would have maintained more accurate and complete records. Accordingly, we find petitioner did not exercise due car in recording or reporting, the understatement was the result of negligence, and the penalty was properly applied.

OTHER DEVELOPMENTS

None.

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