CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION FINAL ACTION SUMMARY

In the Matter of the Petition for Redetermination and Claim for Refund Under the Sales and Use Tax Law of: COMMODORE CRUISES & EVENTS, INC., fka Commodore Dining Cruises, Inc. Petitioner/Claimant	))))))))	 Account Number: SR CH 99-222213 Case ID 424031, 514975 Alameda, Alameda County

Type of Business: Dining cruises

Audit Period: 01/01/04 – 12/31/06

Item	Amount
Understated taxable sales	$1,872,337
Negligence penalty	$16,245
Claim for refund	$225,456

	Tax	Penalties
As determined and protested:	$162,450.21	$16,245.04

Proposed tax redetermination	$162,450.21
Interest	48,814.36
Negligence penalty	16,245.04
Total tax, interest, and penalty	$227,509.61
Payments	-227,509.61
Balance due	$0.00

The Board heard this matter on July 14, 2010, and granted petitioner 30 days to provide additional records and the Sales and Use Tax Department (Department) 30 days to respond. Petitioner's submissions and the Department's response are discussed below under Post Hearing Developments. We find no further adjustments are warranted.

UNRESOLVED ISSUES

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

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

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

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

As long as the Department's calculations resulted in a charge greater than zero per person for food, beverages, mandatory gratuity, and tax reimbursement, the Department accepted the amount calculated as the audited amount of taxable sales for that contract. Where it calculated a charge per

---

[1] Although petitioner regarded its lump sum charge as including a component it characterizes as a yacht "rental" charge, petitioner was not renting the yachts (it did not transfer control of the vessel to a lessee) and did not actually make a charge 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.

person less than zero, the Department estimated taxable sales of $15 per person, unless petitioner provided evidence that the contract had included some type of food and beverages other than a gourmet meal. If the contract involved a non-gourmet meal, or only dessert or beverages, the Department used a lower estimate per person. The Department then added petitioner's bar charges for its separate sales of liquor, soft drinks, and juices to establish petitioner's total charges for food, beverages, gratuity, and tax reimbursement for these cruises. The Department compared petitioner's reported taxable sales for the four-month test period ($143,360) to the audited taxable sales for the same period ($318,854), resulting in an understatement of $175,494, which represents an error rate of 122.41 percent. The Department projected the error rate to reported taxable sales for the audit period of $1,529,563 to establish unreported taxable sales of $1,872,337.

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

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

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

The Department applied the negligence penalty because it concluded that the reporting errors noted in petitioner's prior audits had not been corrected and continued to occur in the current audit period. The Department notes that both the third and fourth audits resulted in an assessment of additional tax based on petitioner's underreporting of its mandatory gratuity charges and food and beverage sales, as in the current audit. The Department also asserts that petitioner was specifically informed in the April 14, 2004 Report of Audit for its fourth audit that it needed to improve its reporting accuracy and that its failure to do so for the current audit period might be construed as evasive in nature. In addition, the Department notes that it assessed a 10-percent negligence penalty in the fourth audit because it determined that petitioner failed to maintain sufficiently accurate and detailed records for sales and use tax purposes, and that failure has not been corrected in this audit period. The Department further contends that the size of petitioner's understatement in this present audit is evidence of negligence.

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

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

CLAIM FOR REFUND

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 and have concluded no adjustments are warranted to the established liability. Accordingly, we recommend that the claim for refund be denied.

POST HEARING DEVELOPMENTS

Based on petitioner's presentation at the hearing, the Board raised five specific questions, which are addressed individually below. At the Board hearing, petitioner submitted a binder of argument and documents. Following the Board hearing, petitioner submitted a summary of port fees paid during 2004, 2005, and 2006 at its home port, as well as invoices for 2006 which reflect the amount of home port fees. The Department reviewed the material provided at and after the hearing and replied by memorandum dated September 30, 2010, concluding that petitioner's submissions did not support a reduction to the audit liability. For the reasons explained below, we concur with the Department's conclusion.

<u>Home Port Fees</u>. As explained above, the Department established taxable sales for the four test months by reviewing each contract and deducting nontaxable charges from the total contract amount. Port fees charged for petitioner's use of ports other than its home port of Alameda were included in the nontaxable charges that were deducted. During the Board hearing, petitioner argued that its home port fees should also be subtracted from gross receipts to compute the audited taxable measure for sales of food, beverages, and mandatory gratuity.

It is undisputed that the home port fees directly relate to petitioner's rental of berthing space at the docks, and for the maintenance thereof, and are incurred whether or not petitioner sells food and beverages. Accordingly, the home port fees are a cost of petitioner's charter service. Since petitioner did not separately itemize any home port fees in its contracts, we conclude that petitioner included this general operating expense in its calculation of its yacht charter fees, which the Department has already excluded from the computed taxable measure. Thus, no adjustment is warranted for home port fees.

Audited gratuity rate. At the Board hearing, petitioner argued that the Department erroneously used a 16.25 percent gratuity rate in determining the measure of tax, and that it should have used $1.50 per person instead. We first note that, for 92 of the 109 contracts in the test period, the Department accepted *petitioner's* reported measure, which included mandatory gratuities at whatever rate *petitioner* imposed. Thus, this contention does not apply to the audited taxable measure for those 92 contracts. For the remaining 17 contracts, the Department did not calculate the gratuity separately. Instead, the Department estimated gross receipts of $15 per person (or less for the contracts for which petitioner established that it did not provide a gourmet meal), including tax and gratuity. It is undisputed that petitioner accepted the $15 per person estimate as reasonable. For this reason alone, petitioner's assertion lacks merit and provides no basis for adjustment.[2] Moreover, we note that the Department has accepted petitioner's stated amounts of charter fees without verification, and has deducted those amounts in its computation of audited taxable sales. Since that computation resulted in a negative amount of gross receipts from food and beverage sales in 17 of the 109 contracts reviewed, we find it likely that the stated amounts of charter fees were overstated. If so, petitioner has already received an unintended benefit, and no further adjustment is warranted.

Money-Losing Contracts. The Board asked that the Department explain why it regarded $15 per person to be a reasonable estimate for sales of food and beverages with respect to contracts for which petitioner may have lost money. As noted above, we find it likely that that petitioner's stated hourly charter fees were overstated. Therefore, without verification of those amounts, we conclude there is insufficient evidence that petitioner lost money on the sale of food and beverages sold through the contracts in question. Further, as noted by the Department, it used amounts less than $15 per person to establish the audited taxable sales related to contracts for which petitioner established that it

[2] From an abundance of caution, we also considered the effect of using $1.50 per person as the amount of the mandatory tip and found that the reduction would be *de minimus.*

did not serve a gourmet meal. We find that an estimate of $15 per person for a gourmet meal is reasonable, and that no adjustments are warranted.

Mark-up Method. Since the Department had established audited taxable sales on a markup basis in previous audits of petitioner, the Board asked the Department to explain why it used a different approach in this audit. We note that the results of a markup audit are only as reliable as the base from which the auditor is working. That is, if either the audited cost of goods sold or the audited markup is not representative, the computed amount of audited taxable sales will not approximate a taxpayer's actual sales. In this case, petitioner did not maintain any records of its food and beverage purchase costs. In addition, petitioner did not separately record the amounts it charged for food and beverages. Accordingly, the Department had neither an accurate cost of goods sold nor sufficient information to compute a representative markup. Since the Department used one of the calculation methods petitioner had used, as well as records actually maintained by petitioner, we conclude that the Department's audit methodology results in a more accurate determination that the markup method.

Negligence. The Board asked during the hearing that the negligence penalty be re-examined. We first note that this is petitioner's fifth audit, and the Department has identified similar errors in each audit. Further, in the most recent prior audit, the Department imposed a negligence penalty, and the Report of Audit Findings for that audit was issued early in the current audit period. Thus, petitioner had actual knowledge of the error and the need to improve its reporting procedures. Despite such knowledge, petitioner again repeated the error, which in itself is negligent. Further, the audited understatement of $1,872,337, which represents an error ratio over 122 percent, is substantial, both as an absolute amount and in relation to reported taxable sales. We find that the level of error is strong additional evidence of negligence. Accordingly, we conclude that petitioner was negligent, and that the penalty was appropriately applied.

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