

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION FINAL ACTION SUMMARY

3 In the Matter of the Petition for Redetermination)
 4 Under the Sales and Use Tax Law of:)
 5 OCEAN PALACE, INC.) Account Number: SR GH 99-451458
 Case ID 425058)
 6 Petitioner) San Jose, Santa Clara County

7 Type of Business: Restaurant
 8 Audit Period: 10/1/03 – 9/30/06

9 Item Disputed Amount

10 Unreported taxable food sales \$357,678

	<u>Tax</u>	<u>Penalty</u>
12 As determined	\$65,456.89	\$6,545.67
13 Adjustment – Appeals Division	-29,514.19	-6,545.67
Post hearing	<u>-6,434.22</u>	<u> </u>
14 Proposed redetermination and protested	<u>\$29,508.48</u>	<u>\$ 0.00</u>
15 Proposed tax redetermination	\$29,508.48	
Interest (tax paid in full 1/28/08)	<u>6,831.42</u>	
16 Total tax and interest	\$36,339.90	
17 Payments	<u>36,339.90</u>	
Balance	<u>\$0.00</u>	

18 The Board heard this matter on July 21, 2009, and ordered the Sales and Use Tax Department
 19 (Department) to conduct a reaudit, expanding the observation test from which the credit card ratio
 20 analysis was derived. The discussion under “Unresolved Issue,” presents the facts as of the Board
 21 hearing, and the results of the Department’s recent reaudit are addressed under “Post Hearing
 22 Developments.”

23 **UNRESOLVED ISSUE**

24 **Issue:** Whether additional adjustments are warranted. We conclude that no further
 25 adjustments are warranted other than those discussed under “Post Hearing Developments.”

26 Petitioner operated two restaurants, “Ocean Palace” and “Ocean Delight Seafood.” After the
 27 audit period, on January 31, 2008, petitioner sold Ocean Palace. For the audit, petitioner provided
 28 federal income tax returns (FITR’s), bank statements, guest checks, daily sales summaries, and partial

1 purchase invoices. The Department examined petitioner's bank deposits and noted that there were no
2 cash deposits in May 2004, January 2006, and September 2006, which suggests that not all sale
3 proceeds were deposited in petitioner's bank account. The Department also found that the book
4 markups of 131 percent, 106 percent, and 122 percent for the years 2003, 2004, and 2005, respectively,
5 were lower than expected for this type of business (typically in the range of 200 to 300 percent).
6 Therefore, the Department decided to establish petitioner's sales based on an observation test
7 consisting of three days at one location and two days at the other, from which it established that credit
8 card sales represented 63.94 percent of total sales. The Department used that percentage and credit
9 card deposits for the audit period to compute an understatement of reported taxable sales of \$793,416.

10 Petitioner contended that the observation test used by the Department does not accurately
11 reflect petitioner's sales for the audit period because the higher weekend sales should be weighted for
12 only two days of the week, Friday and Saturday, rather than for three days (Friday, Saturday, and
13 Sunday) as the Department had done. Petitioner also contended the amount of sales observed on
14 Wednesday, January 17, 2007, was higher than normal due to a church meeting at the restaurant on
15 that day. After the appeals conference, the Department recalculated the taxable measure by changing
16 the weighting of sales on weekends and sales for the remainder of the week, which reduced the
17 underreported taxable measure to \$435,668. Petitioner continues to contend that the amount of sales
18 observed on Wednesday, January 17, 2007, was higher than normal. Petitioner provided a schedule of
19 its Wednesday sales from 2006 and 2007 for Ocean Palace to show that the average sales were not
20 over \$1,000, and a schedule listing the daily sales in 2006 and 2007 for both restaurants. However,
21 since the schedules were not supported by source documents such as guest receipts or credit card
22 receipt slips, we found no further adjustment was warranted.

23 POST HEARING DEVELOPMENTS

24 As directed by the Board, the Department expanded the observation tests. The Department
25 considered performing additional observations of the Ocean Palace Restaurant, but determined that,
26 under the new ownership, it caters to a different customer base. Thus, the expanded test was limited to
27 the Ocean Delight Seafood Restaurant still operated by petitioner. The Department performed an
28 observation test of six additional days, so that, between all the observation tests of both restaurants,

1 each day of the week was tested at least once. Where a day of the week was tested more than once
2 (Wednesday was tested twice, Thursday twice, and Sunday three times), the Department took an
3 average of the tests, so that each day of the week was represented once in the final computations. The
4 Department computed a ratio of credit card sales to total sales of 71.21 percent, an increase of 7.27
5 percent from the 63.94 percent it had previously computed. The Department used the 71.21 percent,
6 along with credit card deposits, to calculate audited taxable sales, which it compared with reported
7 taxable sales to compute an understatement of taxable sales of \$357,678, a reduction of \$77,990 from
8 \$435,668, as previously computed. Based on our review of the reaudit report, we conclude that no
9 further adjustments are warranted. Thus, we recommend that the tax be redetermined in accordance
10 with the Department's reaudit report dated January 4, 2010.

11 **RESOLVED ISSUE**

12 The Department imposed a negligence penalty based upon petitioner's failure to maintain
13 adequate books and records for sales and use purposes. Petitioner underreported its sales by 11.15
14 percent ($\$357,678 \div \$3,206,773$). This is not an exorbitantly high error rate for this type of business,
15 considering that this was petitioner's first audit, but is certainly not insignificant. Petitioner's assertion
16 that it did not understand the requirements for maintaining its records is not particularly persuasive
17 since petitioner had a duty to understand those requirements. Nevertheless, we find in the D&R that it
18 is appropriate to give petitioner the benefit of doubt and remove the negligence penalty (and we
19 cautioned petitioner that the imposition of the negligence penalty based on similar errors in future
20 audits is likely to be upheld).

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22 Summary prepared by Rey Obligacion, Retired Annuitant
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