

## 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 )  
 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>
16 Protested	<u><u>\$320,799.88</u></u>
17 Proposed tax redetermination	\$334,125.84
17 Interest through 6/30/09	289,003.61
18 Amnesty interest penalty	<u>79,993.42</u>
18 Total tax and interest	\$703,122.87
19 Payments	<u>- 23,299.34</u>
20 Balance due	<u><u>\$679,823.53</u></u>
21 Monthly interest beginning 7/1/09	<u><u>\$2,072.18</u></u>

22 This matter was previously scheduled for Board hearing on June 16, 2004, but was postponed  
 23 because petitioner filed a Request for Reconsideration (RFR), which resulted in a Supplemental  
 24 Decision and Recommendation being issued on May 18, 2004, and a subsequent reaudit report  
 25 prepared on August 19, 2004. The reaudit reduced petitioner's tax liability from \$726,112.52 to  
 26 \$334,135.84. This matter was rescheduled for Board hearing on November 10, 2005, but was deferred  
 27 because petitioner filed a settlement offer. The settlement negotiation was not successful, and thus, the  
 28 matter was scheduled for Board hearing on April 28, 2009, but petitioner's representative requested

1 that the hearing be moved to Sacramento. The hearing was scheduled for May 28, 2009, but was  
2 postponed because petitioner's representative had an out-of-state court hearing on the same day.

### 3 UNRESOLVED ISSUES

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

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

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

17 At the time we issued the Decision and Recommendation in this matter, California Code of  
18 Regulations, title 18, section (Regulation) 1603, subdivision (g), second paragraph, provided:

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

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

1 affirmative action to avoid its application. We conclude that this was a mandatory gratuity that is  
2 subject to sales tax.

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

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

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

19 Examples of documentary evidence that may be used to overcome the presumption  
20 include:

- 21 1. A guest check that is presented to the customer showing sales tax  
22 reimbursement and the amount upon which it was computed, without tip  
23 or with the “tip” area blank and a separate document, such as a credit  
24 card receipt, to which the retailer adds or prints the requested tip.
- 25 2. Guest receipts and payments showing that the percentage of tips paid  
26 by large groups varies from the percentage stated on the menu, brochure,  
27 advertisement or other printed materials.
- 28 3. A retailer’s written policy stating that its employees shall receive  
confirmation from a customer before adding a tip together with  
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.

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

4 The available evidence indicates that petitioner cannot overcome the presumption of  
5 subdivision (g)(2)(C) that the subject gratuities were mandatory. We therefore conclude that the  
6 gratuities were subject to tax.

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

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

15 Since the actual recorded amounts of such gratuities were not available, the Department  
16 decided to compute an average daily amount of mandatory gratuities per location. Based on a cursory  
17 review of approximately 100 daily sales reports for two locations, store #1718 (Fresno) and store  
18 #1918 (San Bruno), the Department found that the daily mandatory gratuities ranged from \$30 to \$400  
19 per location, representing a mean amount of \$215 ( $[\$30 \text{ low} + \$400 \text{ high}] \div 2$ ) per day per location.  
20 The \$215 mean amount was applied to the total number of days a location was open during the audit  
21 period (42,300 total business days) to establish audited mandatory gratuities of \$9,094,500 ( $\$215 \times$   
22 42,300) for the audit period.

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

1 are warranted.

2 **AMNESTY**

3 An amnesty interest penalty of \$79,993.42 will apply under Revenue and Taxation Code  
4 section 7074, subdivision (a), when the liability becomes final because petitioner did not apply for  
5 amnesty.

6 The Board may relieve the penalty pursuant to Revenue and Taxation Code section 6592,  
7 subdivision (a), if it finds that the failure to participate in the amnesty program was due to reasonable  
8 cause and circumstances beyond petitioner's control and occurred notwithstanding the exercise of  
9 ordinary care and the absence of willful neglect. A taxpayer seeking such relief must submit a  
10 statement signed under penalty of perjury setting forth the facts on which the claim for relief is based.  
11 By letter to petitioner dated April 17, 2009, we explained the application of the amnesty interest  
12 penalty and petitioner's right to ask for relief. We also provided petitioner a form it could use to  
13 request relief, and asked that it return the completed form by April 27, 2009, if it wished to request  
14 relief of the amnesty interest penalty. Petitioner did not return the form requesting relief, and we  
15 therefore have no basis to consider recommending relief of the penalty.

16 **OTHER DEVELOPMENTS**

17 None.

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19 Summary prepared by Rey Obligacion, Business Taxes Specialist III  
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