

DECISION OF MUNICIPAL TAX HEARING OFFICER

Decision Date: November 7, 2005

Decision: MTHO #235

Tax Collector: City of Tempe

Hearing Date: September 21, 2005

DISCUSSION

Introduction

On March 16, 2005, *Taxpayer* Restaurant (“Taxpayer”) filed a protest of a tax assessment made by the City of Tempe (“City”). After review, the City concluded on March 22, 2005, that the protest was timely but not in proper form. On April 4, 2005, the Municipal Tax Hearing Officer (“Hearing Officer”) granted the Taxpayer an extension until May 19, 2005, to correct the form. On May 19, 2005, the Taxpayer corrected the form of the protest. On May 23, 2005, the Hearing Officer ordered the City to file any response to the protest on or before July 7, 2005. On June 29, 2005, the City requested an extension to file a response. On July 2, 2005, the Hearing Officer granted the City an extension until July 14, 2005, to file a response. On July 13, 2005, the City filed a response to the protest. On July 20, 2005, the Hearing Officer ordered the Taxpayer to file a reply on or before August 10, 2005. The Taxpayer filed a reply on August 10, 2005. On August 11, 2005, a Notice of Tax Hearing (“Notice”) set the matter for hearing commencing on September 21, 2005. Both parties appeared and presented evidence at the September 21, 2005 hearing. On September 23, 2005, the Hearing Officer indicated the record was closed and a written decision would be issued on or before November 7, 2005.

City Position

The City asserted the Taxpayer operated a fast food type of Chinese restaurant in the City. According to the City, the restaurant is open seven days a week. The City conducted an audit of the Taxpayer for the period April 1, 1998 through October 31, 2004. The City concluded the Taxpayer had unreported taxable restaurant income pursuant to City Code Section 455(a) [“Section 455(a)”] with taxes due in the amount of \$23,863.77. The City also assessed late payment penalties of \$2,386.38 pursuant to City Code Section 16-540(b) (“Section 540(b)”) and interest pursuant to City Code Section 16-540(a) (“Section 540(a)”).

The City made the decision to audit the Taxpayer after City personnel had visited the restaurant and observed that cash sales were entered as “No Sale” transactions on the cash register. The City noted that a review of the Taxpayer’s reporting history revealed a significant decrease in reported taxable income over time, which the City concluded was inconsistent with general inflationary trends.

After review of the Taxpayer's operations and records, the City concluded the Taxpayer's internal controls were not adequate to ensure that all cash sales were included in gross income. The deficiencies included the following:

- Although the restaurant has a cash register, cash sales are not recorded in the register; instead, the "No Sale" key is used.
- No reconciliation of reported cash sales to cash guest checks is performed.
- No reconciliation of reported cash sales or cash guest checks to cash in the register drawer is performed.
- Cash sales are not deposited intact; no reconciliation of reported cash sales to bank deposits is performed.
- Daily or regular bank deposits are not made; time logs of a month or more between cash deposits were noted.
- No recognition in the accounting records is given to purchases or expenses paid with cash.

The City asserted the only record maintained by the Taxpayer which provides a minimum control is the pre-numbered guest check. According to the City, all of the Taxpayer's food sales are manually recorded on pre-numbered guest checks by the order taker at the restaurant. Each of the guest checks has a duplicate copy which is provided to the food preparer. The City indicated the pre-ordered guest checks were the source of the income totals reported on the Taxpayer's privilege tax returns. The City asserted that if a properly used guest check is not included in the tabulation, the taxable revenues would be understated with no other controls to detect the omission. As a result, the City proposed an audit approach that would verify that all guest checks were included in the Taxpayer's sales summaries. The City discussed the approach with the Taxpayer's representative at the time, who agreed with the audit approach. The city determined that 5,820 (over 50 percent) out of a total population of 10,759 pre-numbered guest checks used during the sample months were not included in the Taxpayer's reported taxable sales. Based on the nature of the restaurant and the City's observations of the restaurant, the City concluded the cash sales appeared to be unreasonably low compared to total sales. After review of bank deposits for the audit period, the City concluded there was no apparent correlation between bank deposits and reported income.

Based on a review of financial statements of the Taxpayer for calendar years 2002 and 2003, the City determined the Taxpayer's cost of food as a percentage of total sales ranged from 45 percent to 47.1 percent. The City concluded the percentage was unnecessarily high considering the nature of the restaurant. Based on information obtained from the Arizona Department of Liquor License and Controls ("ADLLC"), the expected ranges for the cost of food for restaurants were as follows:

- * Fast Food 20% - 28%
- * Sit down restaurant 24% - 31%
- * Forward Restaurant 30% - 40%

The City noted that the Taxpayers cost of food percentages are substantially higher than all the ranges. The City also noted that when the sales are adjusted for the audit results the Taxpayer's cost of food percentages fall within the middle of the expected ranges for sit down restaurants (approximately 26.5 percent.)

The City inducted the Taxpayer was given an opportunity to provide either the missing guest checks or an explanation of the 5,820 missing guest checks. While the Taxpayer provided explanations, the City concluded the explanations were insufficient to explain the large volume of missing guest checks.

Based on all the above, the City asserted the Taxpayer's records were not adequate to support the gross income reported on the privilege tax returns. The City noted that City Code Section 553(e) ("Section 553") authorizes the City to utilize estimates when the Taxpayer fails to maintain or provide suitable books and records. The City indicates that City Code Section 545(b) ("Section 545") provides that any estimate made by the City must be made on a reasonable basis. Section 545 also provides that the Taxpayer must prove the estimate is not reasonable and correct. The City noted the Taxpayer's authorized representative agreed to the City's sampling approach. The City utilized the number of missing guest checks versus the number of guest checks provided to determine an error rate. Prior to determining the error rate, the City reduced the number of missing guest checks by ten percent as an allowance for lost or unusable checks. The resulting error rate (98 percent) was applied to reported revenues in each period. Because these amounts represented unreported cash sales, the City reduced the revenue amounts by 25 percent because the cash sales on guest checks provided were 25 percent less than credit card sales. The City's estimate increased taxable revenues by 73.5 percent.

The City argued that the Taxpayer has provided no evidence to demonstrate that the City's estimate is not reasonable. While the Taxpayer's new CPA, retained after completion of the audit, indicated he had observed the actual number of individuals who purchased meals was substantially lower than the City's estimate, the City asserted that no documentation was provided to support this contention. As part of the audit process, the City had offered the Taxpayer the alternative of an on-site observation. According to the City, the Taxpayer refused the alternative method.

The City determined during the audit process that food was consumed by employees of the Taxpayer. As a result, the City assessed use tax in the amount of \$577.08 for the cost of food consumed pursuant to City Code Section 16-610 (b)(5) ("Section 610(b)(5)").

The normal statute of limitations to assess additional taxes is four years from the date a tax return is filed. However, the City asserted that City Code Section 550(a)(2) ("Section 540(a)(2)") provides for an extension of the statute of limitations to six years when a taxpayer underreports taxable income in excess of twenty-five percent. The City argued that the Taxpayer had underreported taxable income by 73.5 percent which allows the statute of limitations to extend to six years.

The City assessed late payment penalties totaling \$2386.38 pursuant to City Code Section

16-540 (b)(2)(“Section 540(b)(2)”). The City asserted that the Taxpayer charges sales tax on all sales. As a result, the City argued it was appropriate to assess penalties on the additional tax assessment.

Taxpayer Position

The Taxpayer indicated it operate a “fast food” type of restaurant specializing in Chinese food. The Taxpayer commenced operations at its current location in October of 1992 with seven to eight tables for customers. Depending on the requirements of the business, the Taxpayer indicated it employs between three and six full-time employees. The Taxpayer asserted that all daily accounting was done manually through the utilization of guest checks.

The Taxpayer argued that the audit approach used by the City was inappropriate under the circumstances. The Taxpayer asserted the City’s reliance on the “missing” guest checks was inaccurate. According to the Taxpayer, there are a number of factors why guest checks are missing or not in sequential order such as: mistakes happen and the guest check is voided; a customer cancels an order after the guest check is already filled out; guest checks become unusable because drinks and/or sauces are spilled on them; some guest checks are stolen or taken by mistake; and, other restaurant owners have requested guest checks. The Taxpayer argued that there is not a statute or regulation in the City Code that requires a Taxpayer to use sequentially numbered guest checks as a part of their record-keeping system. In addition, the Taxpayer argued there is no requirement that a taxpayer that purchases and uses generic guest checks to maintain records to account for each and every guest check. The Taxpayer asserted that City Code Section 16-350 (Section 350) only requires the taxpayer “to keep and preserve suitable records and other books and accounts as may be necessary to determine the amount of tax for which he is liable”. According to the Taxpayer, they have met that requirement. The Taxpayer argued that the City cannot assess taxes based upon speculation. The Taxpayer noted that the City may pursuant to Section 350(b), direct a specific taxpayer to keep specific books or records but it is limited to “future reporting periods”; and only if such record-keeping is necessary because the Taxpayer had inadequate books and records. The Taxpayer argued that it produced records that were adequate on their face. The Taxpayer asserted that any “redetermination” made by the City must be “based upon the information contained in the return or records or based upon any information within Tempe’s possession or which comes into its possession.” The Taxpayer argued that the City is not permitted by statute to speculate about documents that do not exist.

The Taxpayer asserted that the decrease in reported taxable income during the audit period was consistent with the economic slowdown experienced by the City during the same timeframe. In a review of reports prepared by the City, the Taxpayer noted the sales tax revenue from year 2001 to 2002 decreased from \$13,951,532 to \$12,148,430. According to the Taxpayer, those results were similar to the Taxpayer’s business slowdown.

According to the Taxpayer, the City grossly overstated the number of individuals who purchased meals. The Taxpayer indicated that the City's allowance of ten percent for missing guest checks is far below the actual number that was destroyed or lost during daily business. The Taxpayer asserted that 54.2 percent is an accurate percentage of guest checks that were destroyed.

The Taxpayer disputed the City's cost of food percentages of 21 to 28 percent as being too low. The Taxpayer indicated that it uses vegetables such as snow peas, which spoil quickly and are more expensive to purchase. The Taxpayers asserted the numbers it originally provided for the cost of food was correct.

The Taxpayer argued that the City improperly assessed use tax on food consumed by employees. According to the Taxpayer, the City assessment was distorted because of a reliance on the missing guest checks. In addition, the Taxpayer asserted that the City had utilized the retail value of the food as opposed to the actual cost of the food.

The Taxpayer argued that the statute of limitations ("SOL") should be limited to four years. The Taxpayer indicated that City Code Section 16-500 ("Section 500") limits the SOL to four years unless the City can prove the actual sales exceed those reported on the returns in excess of twenty-five percent. The Taxpayer asserted that since the returns as filed are substantially correct, the SOL provisions of Section 500 prohibit the City from attempting to assess beyond a four-year period.

Based on the above, the Taxpayer requested the use tax liability be corrected; the tax liability based upon the missing guest checks be corrected; and that the penalties and interest be abated in full.

ANALYSIS

Section 350 requires a taxpayer "to keep and preserve suitable records and such books and accounts as may be necessary to determine the amount of tax." In this case, the Taxpayer failed to keep and preserve suitable records that would allow either the Taxpayer or the City to determine whether all the cash sales were being reported. As a result of the Taxpayer's failure to maintain or provide necessary books and records, the City was authorized pursuant to City Code Section 555 to use estimates. Section 545 requires those estimates to be made on a reasonable basis. In this case the City utilized the guest checks to estimate the Taxpayer's gross income. While there is no requirement in the City Code for the Taxpayer to maintain guest checks, we find this was the best available record to determine a reasonable estimate of gross income. If the Taxpayer had utilized the cash register to record all sales, that record would have been preferable. However, that was not done and we find the City utilized the best available records to determine their estimate. We find the Taxpayer did provide sufficient evidence to demonstrate that some of the guest checks were simply discarded for various reasons, however, there was not sufficient evidence for us to conclude that over 50 percent became unusable. We find the Taxpayer's explanation may have been plausible if the

City had included entire missing guest checks that may have been given to other companies. However, the City only included missing guest checks in which some of the checks were missing. We find the City's allowance of ten percent for lost or unusable checks was little more than speculation, however, we will approve the allowance since it benefits the Taxpayer. We also find it was proper for the City to reduce the estimated gross income to reflect average cash sales were lower than average credit sales. Based on all the above, we find the City's estimate to be reasonable.

While the Taxpayer's on-site observation could be utilized as an attentive basis of estimation, we do not find such a method would invalidate the City's estimate. We also note that the on-site observation was very limited as the observation only totaled approximately three hours. Section 545 makes it clear that when a taxpayer disputes a City estimate that the burden of proof is on the taxpayer to demonstrate that the City's estimate is not reasonable and correct. We do not find in this case that the Taxpayer has met that burden of proof.

We find the information the City obtained from ADLLC provides further support for the reasonableness of the City's estimate for gross income. However, it does not provide support for the City's cost of food utilized to determine the use tax in this case. To be consistent with the City's estimate of gross income, the City must revise its use tax assessment to reflect the cost of food based on the estimate of gross income.

We concur with the Taxpayer that the SOL is normally limited to four years. However, it is also clear in Section 550 that the City may extend the SOL to six years when the taxpayer fails to properly report taxable income in excess of 25 percent. Since we have found the City's estimate of gross income was reasonable, we have concluded the Taxpayer has failed to properly report taxable income in excess of 25 percent. Accordingly, the City was authorized pursuant to Section 550 to extend the SOL to six years.

Lastly, the City was authorized pursuant to Section 540(b) to assess a late payment penalty. Further, we do not find the Taxpayer has demonstrated reasonable cause to have the penalty waived.

FINDINGS OF FACT

1. On March 16, 2005, the Taxpayer filed a protest of a tax assessment made by the City.
2. After review, the City concluded on March 22, 2005 that the protest was timely and in the proper form.
3. On April 4, 2005, the Hearing Officer granted the Taxpayer an extension until May 19, 2005, to correct the form.

4. On May 19, 2005 the Taxpayer corrected the form of the protest.
5. On May 23, 2005, the Hearing Officer ordered the City to file any response to the protest on or before July 7, 2005.
6. On June 29, 2005, the City requested an extension to file a response.
7. On July 2, 2005, the Hearing Officer granted the City an extension until July 14, 2005, to file a response.
8. On July 13, 2005, the City filed a response to the protest.
9. On July 20, 2005, the Hearing Officer ordered the Taxpayer to file a reply on or before August 10, 2005.
10. The Taxpayer filed a reply on August 10, 2005.
11. On August 11, 2005, a Notice set the matter for hearing commencing on September 21, 2005.
12. Both parties appeared and presented evidence at the September 21, 2005 hearing.
13. On September 23, 2005, the Hearing Officer indicated the record was now closed and a written decision would be issued on or before November 7, 2005.
14. The Taxpayer operates a fast food type of Chinese restaurant in the City.
15. The restaurant is open seven days a week.
16. The City conducted an audit of the Taxpayer for the period April 1, 1998 through October 31, 2004.
17. As a result of the audit, the City assessed the Taxpayer for taxes due in the amount of \$23,863.77.
18. The City also assessed late payment penalties of \$2,386.38 plus interest.
19. The City made the decision to audit the Taxpayer after City personnel had visited the restaurant and observed that cash sales were entered as "No Sale" transactions on the cash register.
20. The Taxpayer's reporting history revealed a significant decrease in reported taxable income over time.
21. Although the restaurant has a cash register, cash sales are not recorded in the register.

22. There was no recognition in the Taxpayer's accounting records to purchases or expenses paid with cash.
23. During the audit period, the Taxpayer's food sales were manually recorded on pre-numbered guest checks by the order taker at the restaurant.
24. The pre-numbered guest checks were the source of the income totals reported on the Taxpayer's privilege tax returns.
25. The City proposed an audit approach that could verify that all guest checks were included in the Taxpayer's sales summaries.
26. The Taxpayer representative for the audit agreed to the City's audit approach.
27. The City determined that 5,820 out of a total population of 10,759 pre-numbered guest checks used during the sample months were not included in the Taxpayer's reported sales.
28. Based on a review of financial statements of the Taxpayer for calendar years 2002 and 2003, the City determined the Taxpayer's cost of food as a percentage of total sales averaged from 45 percent to 47.1 percent.
29. Based on information obtained from the ADLLC, the expected ranges for the cost of food for restaurants were as follows: fast food, 20% - 28%; sit-down restaurant, 24% - 31%; and, formal restaurant, 30% - 40%.
30. Prior to determining an error rate for guest checks, the City reduced the number of missing guest checks by ten percent as an allowance for lost or unusable checks.
31. The City applied an error rate of 98 percent to the reported revenues in each period of the audit.
32. The City reduced the estimated revenue amounts by 25 percent because the cash sales on guest checks provided were 25 percent less than credit card sales.
33. The City's estimate increased taxable revenues for the audit period by 73.5 percent.
34. As part of the audit process, the City had offered the Taxpayer the alternative of an on-site observation, which was refused by the Taxpayer.
35. During the audit period, food was consumed at the restaurant by employees of the Taxpayer.
36. The Taxpayer commenced operations at its current location in October of 1992

with seven to eight tables for customers.

37. The Taxpayer employs between three and six full-time employees.
38. During the audit period, some of the guest checks had food or drinks spilled on them and had to be thrown away.

CONCLUSIONS OF LAW

1. Pursuant to ARS Section 42-6056, the Municipal Tax Hearing Officer is to hear all reviews of petitions for hearing or redetermination under the Model City Tax Code.
2. Section 350 requires a taxpayer “to keep and preserve suitable records and such books and accounts as may be necessary to determine the amount of tax...”.
3. The Taxpayer failed to keep and preserve suitable records that would allow either the Taxpayer or the City to determine whether all the cash sales were being reported.
4. The City was authorized pursuant to Section 555 to estimate the Taxpayer’s taxable income.
5. The City’s estimate in this case was reasonable pursuant to Section 545.
6. The Taxpayer failed to prove the City’s estimate was not reasonable.
7. The City’ use tax assessment was based on a cost of food that was not reasonable.
8. A six year SOL was proper since the Taxpayer underreported taxable income in excess of 25 percent.
9. The City was authorized pursuant to Section 540(b) to assess a penalty for late payments.
10. The Taxpayer failed to demonstrate reasonable cause to have the penalty waived

ORDER

It is therefore ordered that the March 16, 2005 protest of *Taxpayer* Restaurant of a tax assessment made by the City of Tempe is hereby granted in part, and denied, in part, consistent with the Discussion, Findings, and Conclusions, herein.

It is further ordered that the City of Tempe shall revise the use tax assessment to incorporate the cost of food calculated after the City's revised taxable income.

It is further ordered that this Decision is effective immediately.

Jerry Rudibaugh
Municipal Tax Hearing Officer