STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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October 24, 2016

VIA INTERNET

Dear Interested Party:

The Audit Manual (AM) is a guide for the Board of Equalization (BOE) staff in administering tax and fee programs. It is available to the public and can be accessed from the BOE web page at http://www.boe.ca.gov/sutax/staxmanuals.htm.

The Business Tax and Fee Department (BTFD) is proposing to revise the following AM Chapters:

- Chapter 8, *Bars and Restaurants*
- Chapter 12, *Construction Contractors*
- Chapter 14, *Appeals Procedures*

The revision material is provided on the following pages for the convenience of interested parties who may wish to submit comments or suggestions. Please feel free to publish this information on your website or otherwise distribute it to your association/members.

If you have any comments or suggestions related to the proposed AM revisions, you may contact the BOE at AM.RevisionSuggestions@boe.ca.gov. Your comments or suggestions must be received by BOE no later than December 27, 2016, in order to be considered by staff. Thank you for your consideration.

Sincerely,

for Chief, Tax Policy Division
Business Tax and Fee Department

Audit Manual

Chapter 8

Bars and Restaurants

~~Sales and Use Tax~~Business Tax and Fee Department

California State

Board of Equalization

This is an advisory publication providing direction to staff administering the Sales and Use Tax Law and Regulations. Although this material is revised periodically, the most current material may be contained in other resources including Operations Memoranda and Policy Memoranda. Please contact any ~~board~~ Board of Equalization office if there are concerns regarding any section of this publication.

No employer shall collect, take, or receive any gratuity or part thereof, paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of such gratuity, or require an employee to credit the amount, or any part thereof, of such gratuity against and as a part of the wages due the employee from the employer. (Labor Code section 351.) If this prohibition is violated, any amount of such gratuities received by the employer will be considered a part of the gross receipts of the employer and subject to tax.

Effective January 1, 2015, Regulation 1603, *Taxable Sales of Food Products*, was amended to make a retailer's reporting of tips, gratuities, and service charges under the Sales and Use Tax Law consistent with how the employer reports the employee's wages for these payments to the Internal Revenue Service (IRS), either as (1) optional tips or gratuities, i.e., tip wages of an employee; or (2) service charges, i.e., non-tip wages of an employee.

Transactions Prior to January 1, 2015

Optional tips are not included in gross receipts and are not subject to tax.

Mandatory tips, such as those applied by a restaurant when a party exceeds a specific number of patrons, are considered part of gross receipts and subject to tax. Each restaurant may have its own policy with respect to the specific number of patrons necessary before a charge for tipping is mandatory. Ex: "A 17% gratuity will be added to parties of 8 or more."

(See Regulation 1603, subdivision (g) for detailed information on transactions involving tips, gratuities and service charges occurring prior to January 1, 2015.)

Transactions On or After January 1, 2015

Regulation 1603, subdivision (h), as amended, does *not* change the rule that an optional payment designated as a tip, gratuity or service charge is not subject to tax and a mandatory payment designated as a tip, gratuity, or service charge is included in taxable gross receipts, even if it is subsequently paid by the retailer to employees.

The IRS defines tips as discretionary (optional or extra) payments determined by a customer that employees receive from customers. Therefore, when a retailer keeps records consistent with reporting amounts as tip wages for IRS purposes, such amounts are presumed to be optional and not subject to tax. If the retailer does not maintain such records, the presumption does not apply and the amounts may be considered mandatory and subject to tax as explained in subdivisions (h)(2) and (h)(3) of Regulation 1603.

When a retailer's records reflect that amounts are required to be reported to the IRS as non-tip wages, or if the employer retains an amount received from the customer and does not pay it to the employee, the amounts are deemed mandatory and includable in taxable gross receipts. (Regulation 1603(h)(2)).

When a business claims that amounts received as tips, gratuities, or service charges are optional payments, an auditor should verify that the taxpayer's records include evidence that such amounts were recorded as tip wages and reported to the IRS as required. General IRS tip-reporting requirements for employees and employers are as follows:

IRS Tip Wage Reporting Requirements - Employee

Employees receiving tips of $20 or more in a calendar month (including cash left by customers, tips customers add to debit or credit card charges, and tips received from other employees) while working for one employer are generally required to report their total tip amounts to their employer by the tenth of the following month in which the tips are received. Employees may use IRS Form 4070, *Employees Report of Tips to Employer,* to report their tips to their employers, or other reporting means as provided by the employer (for example, an employer may implement an electronic tip reporting system for their employees).

IRS Tip Wage Reporting Requirements- Employers

In general, employers are responsible for withholding taxes and reporting their employees' tip wages to the IRS. Employers are required to report wages, including tip wages, on Form 941 *Employer's Quarterly Federal Tax Return* or on Form 944, *Employer's Annual Federal Tax Return.* Employers must file Form W-2, *Wage and Tax Statement* for each employee for which tax was withheld. Employers filing Form W-2 are also required to file Form W-3, *Transmittal of Wage and Tax Statements*. The IRS reconciles amounts reported by employers on Form 941 or Form 944 with amounts reported on Form W-3.

Employers operating large food or beverage establishments are required to report receipts and tips and to determine allocated tips for tipped employees on Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips.* In general, a business is considered a "large food and beverage establishment" if tipping by customers is customary and the employer normally employed more than 10 employees on a typical business day during the preceding calendar year (i.e., the 10-employee test).

Employers operating large food or beverage establishments may be required to allocate tips among employees (for additional information, see IRS Instructions for Form 8027). Employers that allocate tips must give each employee who has been allocated tips Form W-2 that shows the allocated amount in box 8 (allocated tips are not subject to withholding and are not be included in boxes 1, 3, 5, and 7 on Form W-2). Although not reported by employees to their employers, allocated tips are regarded as optional amounts.

Regulation 1603, subdivision (h) includes illustrative examples to assist with the analyses of optional versus mandatory payments. The examples are consistent with our audit approach prior to the amendment. They are also consistent with IRS guidelines in *Revenue Ruling 2012-18* which are used to determine whether a payment made in the course of employment is a tip or non-tip wages. Thus, when retailers do not keep records of tip wages consistent for IRS reporting, auditors should use the examples in Regulation 1603(h) to determine whether a tip or gratuity amount is optional or mandatory.

Additionally, t~~T~~he auditor should discuss tipping with the taxpayer and if necessary examine the taxpayer's payroll records as verification of the taxpayer's policies.

OBSERVATION (SITE) TEST 0810.30

GENERAL

An alternative method to support recorded total sales or taxable sales, and/or establish audited total sales or taxable sales is the observation (site) test. A site test is the physical observation and recording of the activity of the business for a specified period of time. ~~Initially, as a tool in analyzing recorded total/taxable sales, the site test should be performed for an entire day if possible. If the site test is used as the basis to establish audited total and/or taxable sales, to ensure the result is representative, the observation test should generally include several days; one of which should be a weekend, if the business is operated on the weekends. If possible, the auditor should avoid conducting the observation test immediately preceding or following a holiday.~~ To promote consistency, improve efficiency, and to involve the taxpayer in the testing process, auditors are required to complete the BOE-805, *Observation Test Fact Sheet*, before beginning an observation test.

OBSERVATION TEST FACT SHEET

The Fact Sheet documents information about the taxpayer's business operations which assists both the auditor and taxpayer in selecting the most representative test days. To ensure the information is accurate and the taxpayer is informed of the process, the auditor should complete the Fact Sheet *jointly with the taxpayer.*

The back of the Fact Sheet notifies the taxpayer that the auditor has determined an observation test is necessary and provides information about the observation test. The auditor should review the information on the back of the Fact Sheet with the taxpayer and provide additional explanation as necessary.

Both the auditor and the taxpayer must sign the completed Fact Sheet. If the auditor makes any changes or revisions to the Fact Sheet due to additional information provided by the taxpayer or based on the test results, the auditor must discuss those changes with the taxpayer and document the changes as discussed with the taxpayer in the audit working papers. The auditor should provide a copy of the completed Fact Sheet to the taxpayer for their records. Once the Fact Sheet is completed, the auditor and taxpayer should select the test day(s).

SELECTING TEST DAYS

In performing an observation test, the day(s) most representative of ~~the~~ an average sales day should be used when possible. Also, if possible, the auditor should avoid conducting the observation test immediately preceding or following a holiday. A minimum of one to three days is required, depending on the scope of the observation test. Auditors must use the following guidelines to determine the *minimum* number of days to test:

- One day – may be used as a preliminary examination to verify adequacy and/or reliability of records provided by the taxpayer at the start of the audit or to verify the reliability of records provided by the taxpayer during the audit. If the preliminary test reveals a material discrepancy, auditors may use this test as a basis to impeach records. However, this test cannot be used to project sales without expanding the period to a full three days. For preliminary examination purposes, a day is considered the lesser of eight hours or the number of hours that the business is open. For example, if the business is only open from 11:00 a.m. to 2:00 p.m., three hours is one day for testing purposes. If a business is open from 8:00 a.m. to 10:00 p.m., a total of fourteen hours, then eight hours is one day for testing purposes.

- Three full days (minimum) – must be used to project sales (e.g. cash to credit ratio, for-here vs to-go ratio, projecting average daily sales, etc.) A full day is considered all hours that the business is open. If the business is open from 7:00 a.m. to 11:00 p.m., then sixteen hours is one full day for testing purposes.

If the taxpayer requests that the auditor not perform the test for the entire day, or when the auditor believes a full day test is not warranted and the other party agrees, the conversation must be fully documented on the Fact Sheet and the hours for the observation test must be selected collaboratively. When performing the test for less than one full day, if the Fact Sheet indicates the busiest hours are non-consecutive; i.e., lunch rush and dinner rush, those hours *must* be included in the test. In addition, if the transactions that occurred outside of the observed hours appear reasonable, they should be accepted.

For example, the business is open from 9:00 a.m. to 9:00 p.m. The auditor and taxpayer agree to observe lunch hours from 11:00 a.m. to 2:00 p.m. and dinner hours from 5:00 p.m. to 8:00 p.m. If the sales in the unobserved periods of the day from 9:00 a.m. to 11:00 a.m., 2:00 p.m. to 5:00 p.m., and 8:00 p.m. to 9:00 p.m. appear reasonable, they are to be accepted as recorded and incorporated in the observation test for that day.

When selecting the test days, if the Fact Sheet indicates the most representative days are the weekend and/or evening hours, the auditor must include a weekend day and/or evening hours in the selected test period. In cases where the taxpayer refuses to allow the auditor to perform an observation test, alternative audit methods (e.g. bank deposit analysis, marking up cost, etc.) must be used.

OBSERVATION TEST

~~This day(s) may be chosen based on a review of the cash register tapes, sales tickets, and/or a discussion with the taxpayer. The auditor should request the taxpayer to maintain and provide the cash register tape(s) or sales tickets for the test day(s) for later comparison against the auditor's scheduling of sales.~~ When performing the observation test, the auditor should schedule the sales as they are rung on the register or at the time the sales ticket is written. For purposes of the observation test, if the taxpayer or employee asks the customer if an order for cold food is to be eaten "here" or "to-go" and the customer responds "to-go," and the food is served in a condition of "to-go," but subsequent to receiving his/her order the customer consumes a portion of the food at the facilities of the taxpayer, the auditor should regard this sale as a valid sale of cold food sold on a "to-go" basis.

The following factors are important in an observation test and should be considered by the auditor. The auditor should provide documentation and/or comments on the Fact Sheet or in the audit working papers: ~~with respect to:~~

- Days of operation
- Hours of operation
- Seating capacity (i.e., the number or chairs and tables, and whether the seating capacity has changed during the audit period)
- Employees per shift
- Number of shifts
- Menu/ prices/ special pricing (daily specials and two-for-one coupons)
- Banquet room/ catering/ delivery/ take-out and how take-out is rung up
- Cash register controls. How many cash registers? Do they ring out the register after each shift? Are multiple people using the same register? Does the taxpayer operate with an open drawer?
- Occurrence of cash payouts
- How are sales rung up? Are take-out sales, banquet sales, bar sales, etc. recorded differently?
- Is tax charged, is tax included in the price, or is no tax charged?
- Percentage of credit card sales
- Weather conditions. Rainy days may affect establishments with limited seating capacity and increase or decrease the amount of sales sold on a “to-go” basis.
- Have the business operations changed during the audit period (expanded, contracted, new menu items added or items deleted)?
- Have there been any unusual circumstances during the audit period that would affect sales (robberies, fire, and natural disasters)?

~~In addition to the comments with respect to the above,~~ T~~t~~o avoid any misunderstanding, confusion, or perhaps the need for further testing, the auditor should state ~~in~~ on the Fact Sheet or in the audit working papers the criteria that was used in the observation test to establish taxable or exempt sales. In addition, the audit working paper schedule of sales for the observation test should include not only a taxable and exempt column, but if possible should also provide a brief description of the item sold and whether it was sold “to-go” or for consumption at the facilities. ~~The~~ F~~f~~ollowing is a brief example:

Description	Selling price (ex-tax)	Taxable	Exempt	To-go	Dine-in
Toasted bagel	1.00		1.00	X	
Toasted bagel	1.00	1.00			X
Toasted bagel w/coffee	2.00	2.00 Combination		X	
Toasted bagel w/coffee	2.00		2.00 Sold separately	X	
Total	6.00	3.00	3.00		

MULTIPLE LOCATIONS

Generally, auditors should perform an observation test for each location. Performing separate tests for each location is more accurate than applying the test results of one location to multiple locations. This is especially true in cases where the taxpayer's business locations have varying menu items, prices, hours of operation, seating arrangements, etc. When testing multiple locations, a separate Fact Sheet must be prepared (using 3 full days to project) for each location.

The results of an observation test for one location may be used to represent multiple locations only if:

- The business characteristics are similar – same location type (e.g., rural, downtown, etc.), same menu items, prices, hours of operation, number of seats/tables,
- The books and records indicate similar sales and/or sales ratios, and
- The taxpayer agrees to use the results of a test of one location to represent multiple locations.

The auditor must document the agreement to use the results of one location to represent multiple locations on the Fact Sheet.

OBSERVATION TEST RESULTS

The results of the test should be reconciled to the taxpayer's records (e.g., z-tapes, journals) for the day of the test. If differences ~~were~~ are noted, the differences should be analyzed and discussed with the taxpayer. If the results of the tested days are determined to be inadequate or inconclusive, the auditor may expand the test with supervisory approval. For example:

The auditor performed an observation test to calculate a cash to credit ratio with the following results:

Day 1 (Saturday)	Day 2 (Sunday)	Day 3 (Wednesday)
29% Cash/71% Credit	32% Cash/ 68% Credit	72% Cash/28% Credit

The auditor must discuss the results with the taxpayer prior to any further testing. If it is agreed by both the auditor and the taxpayer that the results are representative, the results may be used. The auditor must document the discussion in the working papers.

Alternately, if both the auditor and taxpayer agree that the results are not representative, and both agree that the test should be expanded, the auditor must discuss expanding the test with his or her supervisor. Upon supervisory approval, the auditor must again work with and use the Fact Sheet to select another day(s) for observation.

The results of the observation test should be extrapolated for a period of time, generally a year, and compared to reported/recorded amounts. However, if the taxpayer's records are not available for a representative period, the percentage of error developed in the test period may be projected to the remainder of the audit period. Consideration should be given to the seasonal nature of the business (if applicable) and any other relevant factors should be clearly explained in the audit working papers.

~~If a tax deficiency has been established using the observation test~~When observation tests are used to establish audited sales, an alternative method *must* be used and documented in the audit working papers to support the reasonableness of the audit findings (markup on cost, bank deposit analysis, gross profit and net worth analysis, etc.~~i.e., a reasonableness evaluation~~).

Audit Manual

Chapter 12

Construction Contractors

~~Sales and Use Tax~~Business Tax and Fee Department
California State
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FUNDAMENTAL VERIFICATION GUIDELINES 1205.00

TOTAL SALES 1205.05

Liability for contracting operations normally should be verified on a taxable measure basis. Verification of gross sales generally should be confined to examination and control of revenue and other general ledger accounts to ensure accounting for all classes of transactions.

Typical examples of other than normal operations might be rentals, joint venture operations, dispositions of fixed assets, etc.

TAXABLE BASIS OF CONTRACTOR 1205.10

a) CONTRACTOR ON TAX-PAID BASIS — Some contractors responsible only for tax on cost may elect to pay tax at source and/or report all ex-tax purchases from ~~unpermitized~~ out-of-state vendors ~~on Line 2~~as “Purchases Subject to Use Tax;” thus placing them on a tax-paid basis. In such instances, the auditor should verify that taxpayers are actually responsible only for tax on the purchase cost and that all purchases are properly tax paid or reported. It should also be verified that opening inventory is made up of tax-paid purchases or purchases previously reported as taxable.

b) CONTRACTOR NOT ON TAX-PAID BASIS — The actual source of fixtures, materials, and supplies used on jobs are generally:

   l) Direct purchases for specific jobs

   2) Withdrawals from inventory

   Some contractors maintain detailed and complete job cost records and are able to report directly from job cost folders, which normally contain details of purchases made directly for specific jobs, and stock requisitions for inventory withdrawals. Some contractors report estimated costs.

   Unless the contractor is on a tax-paid basis, the auditor as standard procedure should prepare a reconciliation accounting schedule (cost accountability test/examination) for all costs. A cost accountability test assists the auditor in determining whether the contractor’s tax liability was correctly paid on all costs available for sales or use.

~~c) EXAMPLES OF ACCOUNTING FOR COSTS:~~

ACCOUNTING FOR COSTS 1205.12

It is preferable that a cost accountability test/examination be performed for the entire audit period. (See Exhibits 1 and 2). If accurate inventories are maintained, the cost accountability may be made for individual years with separate errors for each year. If the results indicate under/over-reported costs, the potential debits/credits should be investigated thoroughly and detailed comments made in the audit working papers.

Care must be taken to ensure costs posted in a contractor’s records are for ex-tax purchases of materials and fixtures. Contractors may post tax-paid purchases to these accounts or other costs that are associated with the cost of materials or contracts. Examples of such costs are transportation charges for delivery of materials by common carriers or the cost of subcontracts. All recorded costs must be carefully reviewed. Costs that are not for the purchase of materials or fixtures and the cost of any tax-paid purchases must be removed from the recorded total purchases before completing the cost accountability test.

a) EXAMPLES OF ACCOUNTING FOR COSTS

[Current examples 1, 2, and 3 remain the same.]

b) COPIES OF RESALE CERTIFICATES

When a cost accountability test discloses an ex-tax purchase from a California seller that is subject to tax, in order to document that the applicable tax is the liability of the contractor/purchaser as opposed to the liability of the seller, the auditor must obtain a copy of the resale certificate for each such purchase made from a California seller for which the contractor is the consumer; that is, for purchases of materials and for purchases of fixtures for U.S. Government contracts. (See AM Chapter 4, section 0409.63, *Tax Assessed on Purchaser*).

AM section 0409.63, provides, "When contacting the seller, the auditor may not inform the seller that the auditor's reviewing the purchaser's records. Instead, the auditor is only allowed to inform the seller that he or she is verifying whether the seller has a copy of the purchaser's resale certificate on file, and if so, to request a copy of the certificate."

Resale certificates should be saved in the *Supporting Audit Documents* subfolder in the audit case folder. See AM section 0409.63 for additional information.

Audit Manual

Chapter 14

Appeals Procedures

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Appeals Cases Removed from Board Hearing Calendar 1410.00

This section clarifies the criteria for requesting removal of an appeals case from the Board hearing calendar (calendar) and provides guidance on keeping tax and feepayers informed of the status of their case.

Occasionally, the Business Tax and Fee Department or other BOE Departments (Department) will request removal of an appeals case from the calendar when it is determined that the case is not ready for a Board hearing. When an appeals case is removed from the calendar, the Board Proceedings Division (BPD) typically notifies the tax or feepayer in writing. The Department, when requesting a case be removed from the calendar, must provide the BPD with the reason for the request so that the BPD may include it in its correspondence to the tax or feepayer.

In general, requests to remove an appeals case from the calendar should only be made when:

- New evidence is provided by the tax or feepayer that requires further evaluation and verification.
- New arguments are discovered or presented by the tax or feepayer and/or the Department that require further evaluation and verification.
- Further review is needed of various auditing techniques performed and additional documentation is or may become available for review.

Once the BPD notifies all relevant parties that the case was removed from the calendar and provides the reason for the removal, the BPD then refers the case back to the appropriate section, typically Headquarters Operations Division or Audit and Carrier Division. The section handling the case must provide a status update to the tax or feepayer in writing within 90 days from the date the notification of removal from the calendar was sent by the BPD to the tax or feepayer. The section must then continue to provide the tax or feepayer a written status update (with a copy to the BPD) every 90 days thereafter until the case is resolved or returned to the BPD to place on the calendar.