CALIFORNIA STATE BOARD OF EQUALIZATION

APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: EAST COAST FOODS, INC., dba Roscoe's House of Chicken N' Waffles Petitioner	Account Number: SR Y AS 11-668284 Case ID 444779 Los Angeles, Los Angeles County

Type of Business: Restaurant chain

Audit period: 07/01/01 – 06/30/05

Item	Disputed Amount
Unreported taxable sales	$16,419,143
Penalties	$ 233,624

Tax as determined and protested	$1,349,989.74
Interest through 04/30/12	973,963.18
Negligence penalty	134,999.02
Amnesty-double negligence penalty	46,060.60
Amnesty interest penalty	52,564.30
Total tax, interest, and penalty	$2,557,576.84
Payments	- 3,263.52
Balance Due	$2,554,313.32
Monthly interest beginning 05/01/12	$ 7,855.90

This matter was scheduled for Board hearing October 28, 2011, but was postponed at petitioner's request to allow additional time for its representative to prepare. The hearing was then scheduled for January 31, 2012, but the Board Proceedings Division needed to reschedule it.

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the amount of unreported taxable sales. We find no adjustments are warranted.

Petitioner operates four restaurants specializing in sales of chicken and waffles. The only records petitioner provided for audit were federal income tax returns for 2001, 2002, and 2003, menus, and bank statements. The Sales and Use Tax Department (Department) established audited sales on a markup basis. Since petitioner provided no purchase records and most of petitioner's menu items included chicken, the Department first established the audited amount of taxable sales of meals including chicken by using information regarding the costs of individual chicken pieces, obtained from Foster Farms, and the prices of meals on petitioner's menus. After petitioner objected to the computed markup, the Department conducted a test, along with a representative of petitioner, to establish the weighting of various meals, which resulted in an increase of the audited markup from 774.39 percent to 804.32 percent for menu items containing chicken.[1] To establish the audited cost of chicken sold, the Department reduced purchases of chicken by 12 percent for self consumption and by 5 percent for losses due to theft, contamination of food, and spoilage. The Department used the audited markup and the audited cost of chicken sold to establish audited taxable sales of menu items including chicken of $15,664,179 for 2002 and 2003. The Department then deducted the purchases of chicken from the purchases reported on the federal returns, and it reduced that figure by 3 percent for shrinkage to establish the audited cost of sales of beverages and food items other than chicken. The Department recognized that the majority of those items were sold with chicken meals, and those sales were already included in the $15,664,179. The Department estimated that 30 percent of beverages and food items other than chicken were sold separately (not with chicken meals). It therefore applied 30 percent to the audited cost of those items and used that figure, along with an estimated markup of 325 percent, to compute audited sales of beverages and food sold without chicken of $5,495,713. The Department compared the total audited taxable sales of $21,159,892 ($15,664,179 + $5,495,713) to reported taxable sales of $12,656,731 for 2002 and 2003 to compute a percentage of error of 67.18 percent, which it applied to reported taxable sales for the audit period to establish an understatement of $16,939,040. It deducted the sales of $519,897 petitioner reported on amnesty tax returns and issued a determination based on an understatement of $16,419,143.

Petitioner contends that its reported taxable sales are accurate and asserts that they are supported by the amounts of bank deposits. Accordingly, petitioner asserts that the audit should be based on an analysis of bank statements. Alternatively, if taxable sales are established on a markup basis, petitioner asserts that the purchases of chicken should be adjusted for allowances totaling

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[1] Since the markup was based solely on the cost of the chicken and applied solely to the cost of chicken, it is a higher percentage than would have been the case if it had been based on the cost of all items sold as part of the meals and applied to the cost of all such items.

42 percent rather than the 17 percent allowed by the Department. As support, petitioner provided photographs and Internet articles. In response to the Department's observation that petitioner must have taken steps to minimize waste, petitioner responded that chicken is so inexpensive that changes in procedures to reduce waste are not warranted. Petitioner also suggested that it would like to have the Department observe the restaurant, focusing on the amount of chicken dropped or otherwise contaminated and the number of extra pieces of chicken provided at no extra charge. Further, petitioner argues that the audited sales represent a number of sales that was physically impossible.

With respect to the audited cost of goods sold, we note the Department has made allowances for losses and for self-consumption well in excess of the allowances established in the audit manual, and petitioner has not provided evidence to support its estimate that 42 percent of the chicken purchased is not sold. We find the observation test petitioner suggests would not provide reliable evidence because it could easily be manipulated to petitioner's advantage. We are not persuaded by petitioner's assertion that chicken is so inexpensive that there is no incentive to minimize waste or by petitioner's unsupported statement that 10 percent of the chicken purchased is used to provide extra pieces with chicken meals. In short, in the absence of clear, objective documentation, we find no increases to the allowances for shrinkage, spoilage, or self-consumption are warranted. Also, we reject petitioner's assertion that the audited amount of sales represents a number of sales that is physically impossible. With respect to petitioner's contention that the audited sales should be based on an analysis of bank deposits, we recommended in the D&R that a reaudit be conducted to establish audited sales using an analysis of credit card deposits, if petitioner provided specific documentation for review. Although the Department gave petitioner two opportunities to provide the requisite records, petitioner presented nothing. Accordingly, we find no adjustment is warranted.

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

The Department originally recommended a 25-percent fraud penalty because of petitioner's failure to provide records and the substantial understatement. The Department noted that petitioner had been audited previously and should have been aware of the requirement to maintain books and records and provide them for examination. However, in light of petitioner's explanation that its records had been lost due to theft and damage from severe inclement weather, the Department instead imposed the 10-percent penalty for negligence. Petitioner disputes the negligence penalty on the basis that it did provide records, as well as various economic analyses. Petitioner also argues that the audit would not show a substantial understatement if it had been conducted correctly.

Petitioner provided no purchase records, guest checks, cash register tapes, or daily sales reports for the audit period. Even the daily sales reports petitioner eventually provided for December 2006 (18 months after the end of the audit period) were incomplete. Petitioner had been audited previously and must have realized the importance of records, and its failure to safeguard its records and prevent their loss or destruction is evidence of negligence. All of the samples, analyses, photographs, and written statements petitioner has provided are no substitute for summary records and source documents. In addition, the understatement of reported taxable sales of $16,419,143 (even after petitioner reported $519,897 on amnesty returns) represents an understatement of 63.8 percent when compared to reported taxable sales of $25,734,308. The amount of the understatement and the degree of error are too significant to dismiss, particularly since the sizable understatement represents amounts for which petitioner collected sales tax reimbursement.

Issue 3: Whether relief of the amnesty-related penalties is warranted. We find no basis to recommend relief.

Although petitioner applied for amnesty, filed returns, and paid the amounts reported, it reported only $519,897 on those returns, a very small portion of the actual understatement. Accordingly, with respect to the amount of understatement established in the audit for the amnesty-eligible period, the determination includes an amnesty-double negligence penalty of $46,060.60. Also, when the liability becomes final, an amnesty interest penalty of $52,564.30 will be added.

Petitioner has filed a request for relief of the amnesty-related penalties in which it essentially reiterates its contentions regarding the audit methodology and its explanation for the lack of records. Petitioner has not provided any explanation for its failure to report all of its taxable sales when it filed its amnesty returns, and thus has not demonstrated that such failure was due to reasonable cause or circumstances beyond its control. We recommend that relief be denied.

OTHER MATTERS

None.

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

MARKUP TABLE

Percentage of taxable vs. nontaxable purchases	100%
Mark-up percentages developed	804.32%-meals with chicken 325%-beverages and items not included with chicken meals
Self-consumption of chicken allowed in dollars	About $125,000 per year
Self-consumption of chicken allowed as a percent of total purchases	12%
Losses due to theft, contamination, and spoilage allowed in dollars	About $52,000 per year
Losses due to theft, contamination, and spoilage allowed as a percent of total purchases	5%
Shrinkage of beverages and food items other than chicken allowed in dollars	About $67,000 per year
Shrinkage of beverages and food items other than chicken allowed as a percentage of total purchase	3%