

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) Account Number: SR Y AS 11-668284
Roscoe's House of Chicken N' Waffles) Case ID 444779
Petitioner)
Los Angeles, Los Angeles County

Type of Business: Restaurant chain
Audit period: 07/01/01 – 06/30/05

<u>Item</u>	<u>Disputed Amount</u>
Unreported taxable sales	\$16,419,143
Negligence penalty	\$ 134,999
Amnesty-double negligence penalty	\$ 46,061
Amnesty interest penalty	\$ 52,564
Tax as determined and protested	\$1,349,989.74
Interest through 02/29/12	958,251.38
Negligence penalty	134,999.02
Amnesty-double negligence penalty	46,060.60
Amnesty interest penalty	<u>52,564.30</u>
Total tax, interest, and penalty	\$2,541,865.04
Payments	<u>- 3,263.52</u>
Balance Due	<u><u>\$2,538,601.52</u></u>
Monthly interest beginning 03/01/12	<u>\$ 7,855.90</u>

This matter was scheduled for Board hearing in October 2011, but was postponed at petitioner's request to allow additional time for its representative to prepare.

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

1 including chicken, using information regarding the costs of individual chicken pieces, obtained from
2 Foster Farms, and the prices of meals on petitioner's menus. After petitioner objected to the computed
3 markup, the Department conducted a test, along with a representative of petitioner, to establish the
4 weighting of various meals, which resulted in an increase of the audited markup from 774.39 percent
5 to 804.32 percent for menu items containing chicken (the markup was based solely on the cost of the
6 chicken, and did not include the cost of other items sold as part of the meals). To establish the audited
7 cost of chicken sold, the Department reduced purchases of chicken by 12 percent for self consumption
8 and by 5 percent for losses due to theft, contamination of food, and spoilage. The Department used the
9 audited markup and the audited cost of chicken sold to establish audited taxable sales of menu items
10 including chicken of \$15,664,179 for 2002 and 2003. The Department then deducted the purchases of
11 chicken from the purchases reported on the federal returns, and it reduced that figure by 3 percent for
12 shrinkage to establish the audited cost of sales of beverages and food items other than chicken. The
13 Department recognized that the majority of those items were sold with chicken meals, and those sales
14 were already included in the \$15,664,179. The Department estimated that 30 percent of beverages and
15 food items other than chicken were sold separately (not with chicken meals). It therefore applied 30
16 percent to the audited cost of those items and used that figure, along with an estimated markup of
17 325 percent, to compute audited sales of beverages and food sold without chicken of \$5,495,713. The
18 Department compared the total audited taxable sales of \$21,159,892 (\$15,664,179 + \$5,495,713) to
19 reported taxable sales of \$12,656,731 for 2002 and 2003 to compute a percentage of error of
20 67.18 percent, which it applied to reported taxable sales for the audit period to establish an
21 understatement of \$16,939,040 for the audit period. It deducted the sales of \$519,897 petitioner
22 reported on amnesty tax returns and issued a determination based on an understatement of
23 \$16,419,143.

24 Petitioner contends that its reported taxable sales are accurate and asserts that they are
25 supported by the amounts of bank deposits. Accordingly, petitioner asserts that the audit should be
26 based on an analysis of bank statements. Alternatively, if taxable sales are established on a markup
27 basis, petitioner asserts that the purchases of chicken should be adjusted for allowances totaling
28 42 percent rather than the 17 percent allowed by the Department. As support, petitioner provided

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

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

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

23 The Department originally recommended a 25-percent fraud penalty because of petitioner's
24 failure to provide records and the substantial understatement. The Department noted that petitioner
25 had been audited previously and should have been aware of the requirement to maintain books and
26 records and provide them for examination. However, in light of petitioner's explanation that its
27 records had been lost due to theft and damage from severe inclement weather, the Department instead
28 imposed the 10-percent penalty for negligence. Petitioner disputes the negligence penalty on the basis

1 that it did provide records, as well as various economic analyses. Petitioner also argues that the audit
2 would not show a substantial understatement if it had been conducted correctly.

3 Petitioner provided no purchase records, guest checks, cash register tapes, or daily sales reports
4 for the audit period. Even the daily sales reports petitioner eventually provided for December 2006
5 (18 months after the end of the audit period) were incomplete. Petitioner had been audited previously
6 and must have realized the importance of records, and its failure to safeguard its records and prevent
7 their loss or destruction is evidence of negligence. All of the samples, analyses, photographs, and
8 written statements petitioner has provided are no substitute for summary records and source
9 documents. In addition, the understatement of reported taxable sales of \$16,419,143 (even after
10 petitioner reported \$519,897 on amnesty returns) represents an understatement of 63.8 percent when
11 compared to reported taxable sales of \$25,734,308. The amount of the understatement and the degree
12 of error are too significant to dismiss, particularly since the sizable understatement represents amounts
13 for which petitioner collected sales tax reimbursement.

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

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

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

26 **OTHER DEVELOPMENTS**

27 None.

28 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%