

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:)
JACOB ZACHARIAH, dba Wendy's) Account Number: SR JH 27-778056
Petitioner) Case ID 437728
Ukiah, Mendocino County

Type of Business: Fast Food Restaurant

Audit period: 01/01/00 – 06/30/07

<u>Item</u>	<u>Disputed Amount</u>		
Unreported sales	\$2,227,623		
Penalties	\$ 66,804		
		<u>Tax</u>	<u>Penalty</u>
As determined:		\$163,188.35	\$56,846.35
Amnesty interest penalty added when final			+ 9,957.22
Protested		<u>\$163,188.35</u>	<u>\$66,803.57</u>
Proposed tax redetermination		\$163,188.35	
Interest through 09/30/11		111,925.87	
Fraud penalty		40,797.14	
Amnesty double fraud penalty		16,049.21	
Amnesty interest penalty		<u>9,957.22</u>	
Total tax, interest, and penalty		341,917.79	
Payments		<u>-5,500.17</u>	
Balance Due		<u>\$336,417.62</u>	
Monthly interest beginning 10/01/11		<u>\$788.44</u>	

UNRESOLVED ISSUES

Issue 1: Whether adjustments are warranted to the deficiency. We find adjustments are not warranted.

Petitioner operated a Wendy's fast food restaurant in Ukiah, California under a franchise agreement with Wendy's International, Inc (franchisor). Petitioner obtained a seller's permit with an effective start date of February 1, 1988, and closed the permit effective May 22, 2009, the date on which he informed the Board the restaurant had burned down.

1 The Department used several different audit methods because the records provided by
2 petitioner were incomplete. Petitioner provided handwritten sales sheets for the period January 1,
3 2003, through December 31, 2005, which the Department concluded substantially reconciled with
4 reported sales on petitioner's sales and use tax returns (SUTR's) for those three years. However, the
5 Department also obtained franchisor sales reports for the period January 1, 2003, through December
6 31, 2006, and for those four years, petitioner had reported \$1,318,043 more in total sales on his
7 franchisor sales reports than on his SUTR's, which the Department regarded as unreported taxable
8 sales. The Department regarded the franchisor sales reports as accurate because the total sales
9 compared closely with total gross receipts reported on petitioner's federal income tax returns (FITR's),
10 and the average daily sales from the franchisor sales reports of \$2,292 was comparable to the
11 Department's two-day observation test, of \$2,229 (total sales, excluding tax, of \$2,292 on day one and
12 \$2,165 on day two).

13 Petitioner only provided bank statements for the period January 1, 2007 through June 30, 2007,
14 and for this period, the Department found that bank deposits, after adjusting for tax reimbursement,
15 were \$24,108 more than total sales reported on the SUTR's, which the Department regarded as
16 unreported taxable sales.

17 For the years 2000, 2001, and 2002, the Department noted that the FITR's, obtained directly
18 from the Internal Revenue Service, reflected \$885,472 more in gross receipts than total sales reported
19 on the SUTR's for the same period, and the Department considered the difference to be unreported
20 taxable sales, thereby computing unreported taxable sales of \$2,227,623 (\$1,318,043 + \$24,108 +
21 \$885,472) for the audit period.

22 Petitioner contends that he reported correctly, using his daily cash register receipts and ledger,
23 but is unable to produce those records (except for cash register tapes he provided for the period
24 December 18, 2006, through December 31, 2006) because they were destroyed when a water pipe
25 broke at the business. Petitioner states that he intentionally overstated his gross receipts on the
26 FITR's and on his franchisor sales reports because he was afraid that the franchisor would terminate
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1 the franchise based on its gross receipts policy.¹ Petitioner also claims that his sales were lower than
2 normal for the period January 2003 through December 2006 because of a remodel of the business.
3 However, a letter from the franchisor dated April 9, 2003, indicates that this remodel was to be
4 completed by September 1, 2003, in order to renew the franchise agreement, and there is no evidence
5 that the remodel was not actually completed by that date. Petitioner argues that the audited taxable
6 sales determined by the Department are unreasonable because he had to borrow money during the
7 audit period to pay for the remodel and to pay business expenses, which he would not have done if he
8 actually had the level of income asserted by the Department.

9 We find that it was reasonable for the Department to apply recognized and approved alternate
10 audit methods, which are based on petitioner's own records, to determine audited taxable sales.
11 Petitioner has provided no evidence of the alleged franchisor gross receipts policy. We note that the
12 franchise agreement did allow the franchisor to require petitioner to submit copies of his SUTR's as
13 well as FITR's. As such, we do not understand why petitioner would overstate gross receipts only on
14 the FITR's and not also on the SUTR's if in fact the reason for the alleged overstated sales on the
15 FITR's were as stated by petitioner. Petitioner has not provided any documentation to support his
16 allegations, and we conclude that there is no basis for any adjustment.

17 **Issue 2:** Whether the Department has established fraud or intent to evade sales and use tax by
18 clear and convincing evidence. We conclude that it has.

19 The Department imposed a 25-percent penalty for fraud or intent to evade tax because it
20 believes petitioner intentionally underreported his sales for the audit period in order to avoid paying his
21 full tax liability. Since petitioner obtained his seller's permit in 1988, he has received numerous
22 informational mailings from the Board regarding his sale and use tax liabilities and reporting
23 requirements. The Department argues that petitioner knew or should have known his responsibilities
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25 ¹ Petitioner asserted that the franchisor required a certain threshold of gross receipts and if that threshold were not met, the
26 franchisor had the right to terminate the franchise agreement. However, petitioner provided no evidence of the existence of
27 this policy other than his statements. At the appeals conference, petitioner indicated that he had an idea what the gross
28 receipts threshold amount was, but did not specify that amount. After the Department pointed out that the amounts he
reported as total sales on his SUTR's and the amounts he reported as cost of goods sold on his FITR's indicated he operated
at a loss of \$1,983,827 for the seven years, petitioner responded that he also overstated his cost of goods sold on his FITR's
to compensate for the overstated gross receipts so as to correctly report net income.

1 regarding the Sales and Use Tax Law. Despite this knowledge, petitioner failed to maintain adequate
2 books and records and understated his taxable sales by \$2,227,623 (an error ratio of 65.86 percent).
3 Petitioner also collected sales tax reimbursement on his taxable sales, which is also evidence that he
4 was knowledgeable regarding Sales and Use Tax Law. The Department also notes that petitioner was
5 first contacted for audit in October of 2006 and that petitioner reported significantly (72 percent) more
6 sales in the 4Q06 than had been reported in 3Q06. The Department also had to obtain copies of
7 petitioner's 2000, 2001, and 2002 FITR's from the Internal Revenue Service and the franchisor sales
8 reports from the franchisor.

9 Petitioner's only defense is his admission that he falsified records (FITR's and franchisor sales
10 reports). However, petitioner has not established that he overstated gross receipts on his FITR's or
11 taxable sales on his franchisor sales reports, and therefore we find that petitioner has failed to offer a
12 non-fraudulent explanation for these reporting discrepancies. We find that petitioner was a
13 knowledgeable and experienced businessperson who was aware of his reporting responsibilities.
14 Further, we find that petitioner grossly underreported his sales on a consistent basis throughout the
15 audit period, and that the gross underreporting is evidence of petitioner's intent to underreport his tax
16 liability for evading the payment of tax due.

17 **Issue 3:** Whether the Notice of Determination (determination) was issued timely for the period
18 January 1, 2000, through June 30, 2003. We conclude that it was timely issued for all quarters in the
19 audit.

20 Petitioner executed timely waivers of the statute of limitations that allowed the Department
21 until April 30, 2008, to issue a determination for the period October 1, 2003, through December 31,
22 2004. (Rev. & Tax. Code, §§ 6487, subd. (a), 6488.) Thus, the February 11, 2008 determination was
23 clearly timely for that period, as well as the subsequent quarters. The determination is also timely for
24 the period July 1, 2001, through December 31, 2002, under the amnesty program's ten-year statute of
25 limitations. (Rev. & Tax. Code, § 7073, subd. (d).) In the absence of fraud, the determination would
26 be barred as to the periods January 1, 2000, through June 30, 2001, and January 1, 2003, through
27 September 30, 2003. However, in light of our finding that the deficiency was due to fraud or an intent
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1 to evade taxes (Rev. & Tax. Code, §6487 subd. (a) & (b)), we find the determination was timely for all
2 periods it covers.

3 **Issue 4:** Whether the amnesty penalties should be relieved. We find these penalties should not
4 be relieved.

5 Since petitioner did not participate in the amnesty program, an amnesty double fraud penalty of
6 \$16,049.21 was added, and an amnesty interest penalty of \$9,957.22 will be added when the liability
7 becomes final. Petitioner has submitted a request for relief of the amnesty penalties, signed under
8 penalty of perjury, contending that there was no need for him to file for amnesty since he accurately
9 reported his taxable sales and paid his full tax liability.

10 Petitioner's underreporting for the amnesty-eligible period was \$885,472, which is substantial.
11 This deficiency was based on petitioner's own FITR's, which the Department found to be accurate.
12 Given that petitioner had accurate records of his sales available, we find that petitioner deliberately
13 underreported his sales in an attempt to evade the payment of tax. Therefore, we are not persuaded by
14 petitioner's asserted reason for failing to participate in the amnesty program. Consequently, we
15 conclude that petitioner's failure to participate in the amnesty program was not due to reasonable
16 cause, and there is no basis to recommend relief of the amnesty penalties.

17 **OTHER DEVELOPMENTS**

18 None.

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20 Summary prepared by Thea Etheridge, Business Taxes Specialist II
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